

**CORPORATE GOVERNANCE:  
GOLDEN PARACHUTE FOR MINORITY SHAREHOLDERS**

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**UNIVERSITY OF MALAYA**

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**CORPORATE GOVERNANCE:  
GOLDEN PARACHUTE FOR MINORITY SHAREHOLDERS**

**NG BOON SIONG**

**Dissertation Submitted  
to the Faculty of Law, University of Malaya in Fulfilment of  
the Requirements for the Degree of  
Master of Laws**

**2012**

## ABSTRACT

As rightly put by Sealy (1996), the law has to strike a delicate balance in cases of tussles between the majority and minority shareholders. Although the legal and regulatory apparatus in Malaysia have shown great alacrity in the recent years endeavouring to rewrite the corporate rules and revamp its legal landscape, it remains nigh impossible to legally define a thin crystal clear demarcation line between the protection afforded to the minority shareholders and the consideration of the corporate interest as a whole. Such thorny situations may arise when the court is faced with the dilemma of giving overwhelmed support to the majority at the expense of prejudicing the minority where the court is prepared to condone unfair acts and decisions of the majority. Conversely, the day-today operation of the company may be hindered if the court tends to favour the exasperating demands and objections of the dissatisfying minorities. This predicament inevitably devolves an onerous task of striking a balance upon the court in leaving the internal management to the company whilst ensuring that the interest of the minorities is not imperilled. Hence, it is high time for the best practices of corporate governance to step in and act as the golden scale to complement the imperfection of law in balancing the rights of the majority and the minority shareholders with the holistic view of enhancing shareholder values. As an alternative remedy, the protective measure of corporate governance may well hold the answer to the din of corporate malpractices. This study has an international magnitude but with a focus on Malaysian public-listed corporations which involve the public investors at large. The methodology of this study aims at providing positive descriptive analysis of the corporate governance best practices for the purpose of minority shareholders' activism and protection. The methodology adopted was mainly premised on a qualitative approach via massive literature review and identification of governance mechanisms that focus on the best practices of corporate governance. This study delved into the issues of corporate governance based on content analysis with specific reference to case studies and reports in order to derive a set of best practices of corporate governance for the protection of the minority shareholders. The findings of this research will have significant implications for improving the overall corporate governance practices in Malaysia in that they highlight the protection of the minority shareholders in the corporate governance regime. Unlike most studies on corporate governance issues in Malaysia and East Asian countries which are based on strong quantitative methodological focus and being scattered in numerous disciplines, this research aims to provide a more in-depth legal insights and understanding of corporate governance practices, using qualitative and analytical study based approach. Ultimately, the golden parachute of corporate governance best practices will land the minority shareholders on gold mine of corporate prosperity in order to achieve a higher standard of Malaysian corporate governance. The main objective of this dissertation lies in the formulation of corporate governance best practices for the protection of the minority shareholders.

## ABSTRAK

Seperti yang dinyatakan oleh Sealy (1996), undang-undang perlu mewujudkan suatu keseimbangan yang sesuai dalam kes-kes persengketaan antara pemegang saham majoriti dan minoriti. Meskipun rangka undang-undang dan peraturan di Malaysia telah menunjukkan kemajuan besar pada tahun kebelakangan ini dalam usaha untuk menulis semula peraturan-peraturan korporat dan mengubah landskap undang-undang, ia tetap hampir mustahil untuk menentukan penandaan garisan tipis yang jelas dari segi undang-undang di antara perlindungan yang diberikan kepada pemegang saham minoriti dan pertimbangan kepentingan korporat secara keseluruhannya. Situasi sukar ini akan timbul apabila mahkamah berhadapan dengan dilema bahawa sokongan yang terlalu banyak diberikan kepada pemegang saham majoriti padahal ia akan memprejudiskan pemegang saham minoriti di mana mahkamah bersedia untuk menyokong tindakan dan keputusan pemegang saham majoriti yang tidak adil. Sebaliknya, operasi harian syarikat akan tergugat jika mahkamah lebih cenderung untuk memihak kepada permintaan dan bantahan yg menjengkelkan daripada pemegang saham minoriti yang tidak berpuas hati. Kesusahan yang tidak dapat dielakkan ini merupakan suatu beban pengimbangan besar bagi mahkamah dalam meninggalkan pengurusan dalaman kepada syarikat dan pada masa yang sama memastikan bahawa kepentingan pemegang saham minoriti tidak terjejas. Justeru itu, ia adalah masanya untuk amalan tadbir urus korporat terbaik memainkan peranannya dan bertindak sebagai skala keemasan untuk melengkapi ketidaksempurnaan undang-undang dalam mengimbangi hak-hak pemegang saham majoriti dan minoriti demi meningkatkan nilai-nilai pemegang saham secara menyeluruh. Sebagai remedi alternatif, langkah perlindungan yang dilaksanakan melalui tadbir urus korporat mungkin memegang jawapan kepada masalah penyelewengan korporat. Kajian ini mempunyai magnitud antarabangsa tetapi dengan fokus kepada syarikat-syarikat awam tersenarai di Malaysia yang melibatkan pelabur-pelabur awam. Metodologi kajian ini bertujuan untuk menyediakan analisis deskriptif yang positif mengenai amalan tadbir urus korporat terbaik bagi perlindungan pemegang saham minoriti. Kaedah yang digunapakai terutamanya berdasarkan pendekatan kualitatif melalui kajian literatur yang banyak dan identifikasi mekanisme tadbir urus yang memberi tumpuan kepada amalan tadbir urus korporat terbaik. Kajian ini mengulas tentang isu-isu tadbir urus korporat yang berdasarkan analisis kandungan dengan rujukan khusus kepada kajian kes dan laporan untuk menggubal satu set amalan tadbir urus korporat terbaik bagi perlindungan pemegang saham minoriti. Penemuan-penemuan kajian ini akan mempunyai implikasi yang besar dalam memperbaiki keseluruhan amalan tadbir urus korporat di Malaysia di mana perlindungan pemegang saham minoriti dalam rejim tadbir urus korporat akan diberi perhatian. Tidak seperti kebanyakan kajian mengenai isu-isu tadbir urus korporat di Malaysia dan negara-negara Asia Timur yang berfokuskan metodologi kuantitatif yang kuat dan bertaburan di pelbagai disiplin, penyelidikan ini bertujuan untuk memberi satu pandangan dan pemahaman undang-undang yang lebih mendalam tentang amalan tadbir urus korporat, dengan menggunakan pendekatan berasaskan kajian kualitatif dan analisis. Akhirnya, payung terjun keemasan amalan tadbir urus korporat terbaik akan dapat mendaratkan pemegang saham minoriti di atas lombong emas kemakmuran korporat demi mencapai standard tadbir urus korporat Malaysia yang lebih tinggi. Objektif utama disertasi ini terletak dalam penggubalan amalan tadbir urus korporat terbaik untuk perlindungan pemegang saham minoriti.

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## **CHAPTER 1**

### **LITERATURE REVIEW**

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#### **1.1 Introduction**

This dissertation will set out to show that there is a dire need for a set of corporate governance best practices for the protection of minority shareholders. It will argue and make a case for the adoption of the notion of corporate primacy over the concept of shareholder primacy and director primacy. The overriding purpose of this dissertation is to propose the formulation of a set of best practices for the protection of minority shareholders. It is argued that this will go a long way in preventing corporate scandal like those we have seen in the recent past.

First of all, chapter 1 will carry out a literature review of the current state of minority shareholder protection regime in Malaysia. This chapter will also provide a background to this study. The purpose is to identify any knowledge gap that gives rise to the research question of this dissertation. This will be followed by an elucidation of the research objectives and justification of this study. The methodology used will also be explained in this chapter.

Chapter 2 will then embark on an overview of the well-established corporate governance principles and models. This will be followed by chapter 3 which will review the existing corporate governance framework in the context of the protection of minority shareholders. In chapter 4, the concept of corporate primacy that will set forth

the formulation of corporate governance best practices in Malaysia will be examined.. Chapter 5 will discuss a set of corporate governance best practices which will provide the utmost safeguards to minority shareholders. Before reaching the realm of the desired protection, paramount consideration is given to the essential elements (see Illustration 1.1 below) that constitute the pillars of corporate governance best practices in the long run. Finally, a set of corporate governance best practices will be spelled out in chapter 6 based on the discussions in chapter 5.

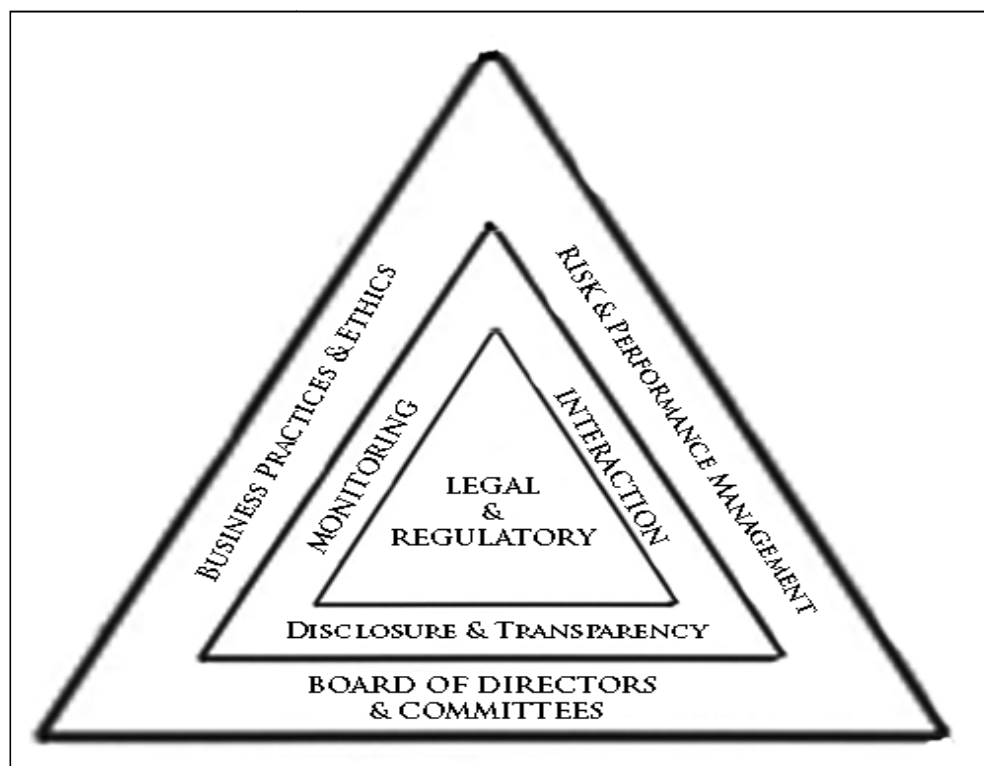


Illustration 1.1 Pillars of corporate governance best practices

## 1.2 Literature Review

In the pages that follow, literature review is carried out to examine background to this study and the ongoing discussions on the subject of corporate governance in relation to

the research question of this dissertation. From such literature review, any knowledge gap will also be identified and addressed in order to provide justification for this study. In addition, this chapter will also examine whether there is any need for study on any single governance model or structure that may better protect minority shareholders. The discussion on the protection of minority shareholders, therefore, provides a theoretical background to this study which will then lead to the formulation of corporate governance best practices.

### **1.2.1 Background**

Generally, a majority of the stock investors, unless they manage and control the companies, are minority shareholders. They include those who buy few lots of shares in the stock market and those who invest in unit trusts or any investment-linked products controlled by corporations, banks or financial institutions, whether listed or unlisted. Previously, minority shareholders have largely depended on two common law principles set out in *Foss v Harbottle* (1957)<sup>1</sup> where only corporation, not individual shareholders can take action against any wrong that has been done to a corporation, and that the wishes of majority members of a corporation should, in general, prevail in the running of the corporation's business, not minority (Drury, 1986).

Furthermore, a common dilemma faced by minority shareholders is that of majority shareholders' control over the board and management of a corporation. Often, such a control is done unfairly by a few, acting in concert for their own interests which minority shareholders feel could be at their expense. More often than not, oppression occurs when majority shareholders, having substantial control of a corporation,

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<sup>1</sup> (1957) Camb LJ 194.

dominate and exercise their power to run and manage the corporation's affairs for their personal gains in total disregard to minority shareholders. Similarly, minority shareholders would normally have no control or complete information over how directors and management conduct their duties in entering into substantial transaction involving the corporation's property as well as the hidden motives behind such transaction. Having no access to inside information, they are unable to block any transactions concerning with "connected persons or related parties" between corporations on the one hand and directors or majority shareholders or persons connected with them. Such transactions can often be manipulated at the expense of minority shareholders or investors.

In Malaysia, Section 181A-E of the Companies Act 1965 now allows shareholders to take a direct action against the company, therefore avoiding the rule in *Foss v. Harbottle*. Under the Companies (Amendment) Act 2007, the statutory derivative action was introduced via Section 181A-E to further enhance remedies available to minority shareholders where they may bring, intervene in or defend an action on behalf of the company in the company's name with the leave of court. Nonetheless, this kind of derivative action normally entails a potentially long and expensive trial which often ends up in futile exercise of rights by minority shareholders. As a matter of law, it appears that the Malaysian court would not simply entertain a lawsuit taken by a minority shareholder who is unhappy over some decision made by a board which has acted within its executive powers as "such matters should and could be resolved by shareholders in general meeting" (*Soh Jiun Jen v. Advance Colour Laboratory Sdn Bhd & Ors* [2010]<sup>2</sup>). This majority rule was also affirmed by the Privy Council in *Re Kong Thai Sawmill (Miri) Sdn Bhd; Kong Thai Sawmill (Miri) Sdn Bhd & Ors v. Ling Beng*

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<sup>2</sup> [2010] 4 CLJ 897.

*Sung* [1978]<sup>3</sup> where Lord Wilberforce agreed that “those who take interest in companies limited by shares have to accept majority rule”. The predominant majority rule also means that a minority shareholder would usually face difficulties in challenging the wrongdoings done by directors who also control a majority stake in a corporation. To make matter worse, the sanctity of Section 181 can also be manipulated by majority shareholders to their advantage since the term “member” is not limited to minority shareholders per se. In *Owen Sim Liang Khui v. Piasau Jaya Sdn Bhd* [1996]<sup>4</sup>, the Federal Court held that Section 181 is also made available to majority shareholders “where they are unable to exert their will at a general meeting of the company” although the decision of the High Court in *Ganeswary d/o Ponnudurai v. Prismatic Sdn Bhd* [1994]<sup>5</sup> spoke to the contrary.

As rightly noted by an eminent author, the law has to strike a delicate balance in cases of tussles between majority and minority shareholders (Sealy, 1996). Although the legal and regulatory apparatus in Malaysia have shown great alacrity in the recent years endeavouring to rewrite the corporate rules and revamp its legal landscape, it remains nigh impossible to legally define a thin crystal clear demarcation line between the protection afforded to minority shareholders and the consideration of the corporate interest as a whole. Such thorny situations may arise when court is faced with the dilemma of giving overwhelmed support to majority at the expense of prejudicing minority where court is prepared to condone unfair acts and decisions of majority. Conversely, the day-to-day operation of a company may be hindered if courts tend to favour the exasperating demands and objections of the dissatisfying minorities. This predicament inevitably devolves an onerous task of striking a balance upon the court in

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<sup>3</sup> [1978] 1 LNS 170.

<sup>4</sup> [1996] 4 CLJ 716.

<sup>5</sup> [1994] 4 CLJ 671.



leaving the internal management to the company whilst ensuring that the interest of minorities is not imperilled.

In the absence of sound corporate governance system, how directors and management can be entrusted to play their role honestly and accountably in such transactions is a real challenge. As a result, there is no one set of laws or regulations that is adequate in protecting minority shareholders in view of the fact that it, at most, provides cause of action for them to seek remedy against majority shareholders or board in the court of law. The damage or harm caused to minority shareholders could not simply be undone with such initiation of court proceeding via derivative claim since it is a “mere matter of procedure in order to give a remedy for a wrong which would otherwise escape redress” (*Burland v. Earle* [1902]<sup>6</sup>). Rather, the discussion on good corporate governance will certainly provide the necessary preventive measures for the purpose of preserving the value of minority shareholders via the advertence of corporate malfeasance.

Having said, the ensuing parts of this chapter will examine and discuss the existing literatures on corporate governance issues in order to determine whether there is any knowledge gap that can give rise to the research question of this dissertation as well as the justification for this study.

### **1.2.2 Knowledge Gap, Research Question and Justification for Study**

In the wake of the global financial crisis in 2008, the corporate world was truly rattled by the credit crunch which unmasked the Bernard Madoff (Madoff) scandal. Ironically,

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<sup>6</sup> [1902] AC 83.

over the past 16 years, Madoff Investment Securities LLC had been examined multiple times by the Securities and Exchange Commission and other regulatory bodies in the United States. The fact that Madoff's alleged \$50 billion Ponzi scheme could be swept under the carpet and gone undetected under the radar for so long raises the questions of the effectiveness of regulatory mechanisms in the USA and other parts of the world. This begs the question - is the Madoff scandal a failure of existing legislation in the USA, or of a failure of the regulators to enforce the legislation? This begs further question – or is it a failure of implementation of corporate governance best practices within the corporation itself? The Madoff's lesson has caused enormous losses to the investors and shareholders at large. The lesson learnt here is that the failure to implement an effective system of corporate governance would inevitably lead to such corporate scandals.

Although the discussion on corporate governance is by no means a new phenomenon, the real impetus for international corporate law reform found its root from the Enron scandal itself and the myriad of corporate fiascos such as the spectacular collapses of WorldCom, Tyco and Global Crossing in USA, Parmalat S.p.A. in Italy, HIH Insurance in Australia, and Asia Pulp & Paper in Indonesia that came in its wake. The local scene was also captured by the notorious Transmile Group Berhad (Transmile) scandal. It is believed that no corporation wishes to be the next Enron or Transmile. This is because the slightest hint of corporate fraud scandal could send the price of a company's stock plummeting and bring chill to its corporate performance which will in turn put minority shareholders' interest at stake. In relation to this, weak corporate governance has often been named as one of the contributory factors of the financial crisis (Mitton, 2002; Suto, 2003). The aftermath of the Asian financial crisis in 1997 has sharpened the impetus for the adoption of a more concerted and holistic approach towards a comprehensive

corporate governance reform in Malaysia. It has since prodded the formation of a High Level Finance Committee on Corporate Governance to reform the legal and regulatory framework in order to create sound corporate governance standards as well as to develop a code of best practices in corporate governance.

Until fairly recently, corporate governance was not an issue that attracted much public attention. It was only a topic reserved for discussion in boardrooms or in academic forums. Corporate governance “has now become a mainstream concern – a staple of discussion in corporate boardrooms, academic meetings, and policy circles around the globe” (Claessens, 2006). At present, there is a panoply of literatures on corporate governance that advocates the efficacy of different corporate governance structures and the superiority of various distinctive corporate governance models. However, dissident voices do exist. While there is surmounting evidence of failure of certain corporate governance structures and models to enhance corporate performance, the present empirical evidence is vastly diverse and only provides little coherent evidence for the formulation of corporate governance best practices. One possible explanation is that existing literatures have not been adequately comprehensive to discuss on all intertwined determinants of good corporate governance. Excessive attentions are drawn to discussions on what is the best corporate governance model without having in-depth analytical study on the “winning” factors of corporate performance and conformance.

Hitherto, scholars have tried to reconcile the conflict between minority shareholders and majority shareholders but thus far this has not been done in the context of corporate governance, even though discussion of corporate governance issues has been thriving in Malaysia for more than a decade now. It is inevitably that board tussles between rival factions and companies will negatively impact the company’s performance in the

market when they take too long or become too legalistic to be resolved. Minority shareholders who are caught in the middle may regard this prolonged fight as an act driven by selfishness and a 'couldn't-care-less attitude' where they are left with no remedies at the crossroad. As minority shareholders share a risk that is similar to the owners of a company, they deserve equal protection. Most researchers seem to make the assumption that inadequate protection of minority shareholders and failure of effective implementation of good corporate governance have given rise to expropriation of minority rights by majority shareholders. However, most of the studies was also carried out on a piecemeal basis based on specific components of corporate governance such as the accountability of the board of directors, board structure and size, corporate governance structure and performance (Haniffa & Hudaib, 2006, Khatri, Leruth, & Piesse, 2002), separation of ownership and control (Fama & Jensen, 1983, Claessens, Djankov, & Lang, 2000) and so forth. It seems that there is limited research on protection of minority shareholders from the perspective of corporate governance.

Many studies in various disciplines like finance, accounting, management and economics have been conducted as to whether corporate governance has any implication on the corporate performance. Much debate exists on the issue of whether the implementation of corporate governance could lead to the enhancement of corporate performance and value based on empirical and explanatory analyses. In this regard, Shabnam et al. (2009) conducted empirical survey on 10 Malaysian corporations that did not practice good corporate governance and vice versa. It was found that there was no difference in corporate performance between those corporations. Studies have also been carried out to determine the correlation of board structure, composition and size with corporate performance (Coles, McWilliams & Sen, 2001; Hermalin & Weisbach, 2001; Bhagat & Black, 1999; Klein, 1998; Baysinger & Butler, 1985). Common

empirical studies delved into the relationship between different structure of corporate governance and managerial behaviour or corporate performance (Core, Holthausen & Larcker, 1999, Zahra & Pearce, 1989, Becht, et al., 2002). López-Iturriaga, López-de-Foronda and Santamaría (2007) examined the relationship between ownership concentration and firm performance in terms of the mechanisms of corporate governance. This study also focused on the extent of control mechanism in resolving agency problem relating to conflicts of majority and minority shareholders. Demsetz and Lehn (1985) argued that high ownership concentration stimulates more managerial monitoring which would subsequently lead to higher corporate performance. Nevertheless, there is no conclusive outcome from studies associated with the relationship between board characteristics and corporate performance. Some studies found little evidence to support that board characteristics have a positive impact on corporate performance (Weir & Laing, 1999; Dalton, Daily, Ellstrand & Johnson, 1998) whilst other studies suggested otherwise (Bonn, 2004; Kiel & Nicholson, 2003). It would be fruitless to examine the board characteristics when the fiduciary duties of the board are essential to corporate performance (Abdullah, 2004).

Be that as it may, it seems that there is agreement among the researchers and authors that corporate governance and its principles have a positive correlation with the level of corporate performance (Chiang, 2005). However, the lacking of research interest in the area of governance best practices proves to be difficult for directors or officers to effectively implement governance best practices that will eventually lead to the improvement of corporate performance. Similarly, Bhimani and Soonawalla (2005) rightly pointed out that corporate performance largely depends on the tools and methods of best practices which can be more easily tailored and implemented. While there is growing evidence of the failure of some governance structures to enhance corporate

performance, the empirical evidence to date is mixed and gives little solid indication for the shape of a most preferable governance structure. Thence, the research question of this dissertation is not framed with regard to the impact of good corporate governance on corporate performance since there is abundance of diverging views and research findings on the issue. Furthermore, corporate performance is measured in financial terms depending on other external factors apart from good governance. It is of utmost importance that the research direction should not be mainly driven towards the interrelationship between corporate governance and corporate performance since there is an ardent research need of formulating a set of corporate governance best practices in order to protect minority shareholders from illicit corporate activity or unscrupulous board behaviour.

Thus far, the aforesaid literature review revealed that there is scant literature on the formulation of a set of corporate governance best practices for the protection of minority shareholders. Although most of the authors acknowledged that corporate governance is a subject worthy of academic consideration, it is hard to find that they touch on the practical insight into governance principles and the implementation of best practices within a corporation. For too long corporate governance has been scrutinised via a single analytical lens that offers partial insights, but cannot begin to examine the full dimensions of the continuing conflict amongst shareholders, or offer convincing vindications and explanations on the appropriate governance system or structure. The richness and complexity of the ever-changing phenomena involved in corporate governance requires the application of a range of theoretical critiques to understand more fully the dilemmas involved. Good business ethics dictates excellent compliance with good corporate governance code even if pure altruism does not induce sufficient motivation for the heightened interest in corporate governance code of best practices.

As such, this dissertation attempts to close the gap in the existing literatures by formulating a set of corporate governance best practices for the protection of minority shareholders in addition to the existing corporate governance code in Malaysia.

To a certain extent, the gap in the research area has been addressed by regulatory guidelines and code on governance best practices in Malaysia. For instance, the Report on Corporate Governance by the Malaysian High Level Finance Committee (1999) which was codified into the Malaysian Code on Corporate Governance 2000, the Bursa Malaysia's Corporate Governance Guide (2009), and The Institute of Internal Auditors Malaysia's Statement on Internal Control (2000). Nonetheless, the "cost" of such literature is that not much explanation and discussion has been offered on the practical application of such principles for the purpose of implementing best practices. Rather, they are more of a compilation of regulatory guidelines and codes which merely creates box-ticking approach by directors and auditors. Although the Malaysian Code on Corporate Governance 2000 was revised in 2007, the best practices provided under the revised Code are still largely the same with the old Code. The Code proves to be inadequate in terms of the best practices due to rapid evolvement of the corporate world. The Code should have contained more new provisions of best practices to enable directors and corporations to incorporate into their governance system. Hence, there remains a considerable gap of knowledge in this area of research which necessitates further analyses on the applicable governance best practices in the spirit of good corporate governance principles. The analysis of this dissertation does not end at the doorstep of explaining and examining the practical implementation of such best practices but it continues to formulate a set of governance best practices in addition to the existing Malaysian governance best practices code.

Having said that, Minority Shareholders Watchdog Group has also initiated the Malaysian Corporate Governance Index (MCG) 2010 which identified the need for improvement in the realm of independent directors, duality of CEO and Chairman, transparency of nomination process and remuneration policy, risk management and other related issues. In this regard, this dissertation sought to fill in the room of improvement for the identified area of issues with the aim to contribute to the corporate governance regime in Malaysia. Instead of the controversial research regarding the impact of corporate governance on corporate performance, the primary research question of this dissertation centres on what are the corporate governance best practices that could provide adequate protection for minority shareholders.

As the recent financial turmoil takes centre stage, it raises a key research question of whether there should be an equivalent single model on corporate governance applicable to all corporations throughout the world. The OECD Corporate Governance Principles (2004) represents the initial attempt to reach a global consensus as to what constitutes good corporate governance principles. These recent efforts protrude the fundamental elements underlying the universal principles – fairness, transparency, responsibility and accountability as the vital factors that transcend both legal and national boundaries. The International Corporate Governance Network (ICGN) has adopted these OECD Corporate Governance Principles as the necessary bedrock of good corporate governance. The ICGN urged corporations to amplify the principles to give them sufficient force for better governance and to implement them even in the absence of any mandatory legal requirements to implement. However, the ambitious approach of OECD has somehow overlooked the difficulties of attempting to implement general principles across countries from different levels of economic, cultural and legal development. It has been argued that this aspiration should not even be fathomed, for



corporations will be better off focusing on cleaning up their own backyards. Convergence may occur in specific areas such as financial reporting or in disclosure standards, but a global standard is simply not feasible (Stephan 1999) since even “any attempt to assess the governance of public firms around the world should depend critically on ownership structure” (Bebchuk & Hamdani 2009). Despite that, Ho Khai Leong (2005) added that “the OECD principles are by no means carved in stone” in that they provide a general framework for countries to shape the corporate governance principles according to their unique developmental experiences to build their own rules.

It is fair to conclude that the prevalent corporate governance systems in the developed economies today is the Anglo-American model which is “market-based” – widely dispersed shareholders and a fairly vigorous corporate control via take-overs. The other system can be reflected by the “relationship-based” system in Japan and Germany which is based on a more concentrated ownership structure – large bank and inter-corporate holdings with conspicuous absence of control through take-overs (Chew, 1997). On the other hand, corporate governance structure in Southeast Asia countries is predominantly modelled upon “family-controlled” business system (Yeh, Lee & Woidtke, 2001). Prominently, public listed corporations are part of enterprises network supervised by family-owned holding corporations with minority shareholders as their public investors (Young, 2002). In practice, it is not uncommon to see that the ownership of a company is controlled by a few shareholders, who are called as “controlling shareholders” and the ownership structure is centralised. Despite such difference in governance structures, one obvious position predicted that global competition will force convergence in diverse corporate governance models. As markets globalise and corporations having very difficult governance systems are compelled to compete head-to-head, both in labour and capital markets, a Darwinian struggle

becomes inevitable, out of which the most efficient form should emerge dominant (Easterbrook & Fischel 1991). This position is, however, in contrary with the other view that convergence of corporate governance models is unlikely to happen since “different corporate governance systems are associated with peculiar managerial decision-making criteria, temporal orientations, and diachronic responses to the business cycle” (Goldstein, 2001). As a result of globalisation, Guillén (1999) noted an interesting legal argument against convergence in corporate governance models that “corporate law is intimately related not only to social custom but also to other legal areas, such as banking, labour, tax, and competition law, that would be exceedingly hard to change all at once because of the various interests created around them”. On this note, Soederberg (2003) has been strenuously insisted that the standardisation of corporate governance codes and practices is a new imposition of corporate disciplinary landscape upon the developing world by politically dominant international agencies.

Generally speaking, there is no irrefutable indication that any single model of corporate governance leads to a more superior corporate performance. The Enron debacle has eroded confidence in the proposition that the Anglo-American corporate governance model is inherently superior” (Bicksler, 2003). In a similar spirit, Kala Anandarajah (2004) augured well that “there is no conclusive evidence that having appropriate corporate governance procedures and practices increases shareholder value” since it varies not only between corporations in a country but also over time for any individual corporation. In 1990, Merton H. Miller, a Nobel Laureate Economics recipient argued that “per se none of the corporate governance models dominates and none is intrinsically superior to the others”. Moreover, the western governance mechanisms may not be suitable for transitional economies like Malaysia (Haniffa & Cooke, 2002). Regardless of whether such convergence will materialise or not, all the above arguments

collectively point to the push for a set of corporate governance best practices that suits the best interest of minority shareholders. Be that as it may, the most notable challenge now is to shy away from the intense focus on a set of international corporate governance standards to dealing with the “hard” issues of practical application and the effective implementation of sound corporate governance practices in which each country must define for itself the best corporate governance framework. Cadbury (2004) advised that nations and corporations are best to embark from where they are and to build on their existing structures and systems. Perhaps, the Malaysian corporate governance standard may be benchmarked against the governance models in other countries in order to lift up the local standard to the international level.

Notwithstanding the reality of this argument, it is strongly believed that a well-crafted corporate governance model which outlines the important characteristics of excellent corporate governance practices would inevitably provide an impenetrable framework for corporations to comply with. In this context, corporate boards and management can then opt to adopt the best corporate governance model as their own with the view of implementing a balanced corporate control mechanisms and effective oversight of the directors’ and officers’ accountability. These implementations can be carried out via the maximum involvement of minority shareholders and auditors. Essentially, the quest for a distinctive way to make a dent in global competition rather than to converge on a best model is preferable for corporations in local context since “globalization seems not to be about convergence to best practice, but rather about leveraging difference in an increasingly borderless world” (Guillén 2001). Hence, a more flexible and constructive corporate governance model which takes cognisance of the pace and level of economic development gap as well as the cultural differences is most instructive here. All things being equal, the simpler model is preferable to the more complex. Here, the simpler

model is that the parallel disciplines of superior corporate performance and strict corporate conformance should be merged to create a best practice model for corporate governance that keeps all stakeholders and regulators satisfied. Although this dissertation briefly discusses on the various corporate governance models regime, it will not delve too deeply into the different models of corporate governance. Such a discussion will be neither feasible nor desirable within the context of this dissertation which aims to formulate a set of corporate governance best practices that champion the interests of minority shareholders.

The time has come for us to acknowledge the reality that there will never be one optimal governance structure or model since no two economies, two corporations, two legal spectre or two cultures are exactly of the same dimension, resulting in extremely complicated corporate governance issues. A more probable and fruitful finding of the existing literatures might be the increasing focus on minority shareholder interest and identification of governance best practices rather than seeking to search for some specific mechanisms which are universally applicable. Instead of exhausting efforts to nail down on universally applicable governance mechanisms, the remainder of this dissertation attempts to suggest a more practical and functional outcome of qualitative research which emphasises on minority shareholder interest and concerns.

Bearing the research question in mind, the findings of this dissertation will contribute to the study of corporate governance to a large extent. The formulation of a set of governance best practices would serve as an all-inclusive guideline for the “preservation of shareholder value” that will put in place a stronger safety net for minority interest. At this juncture, it does not matter whether the best corporate governance model adopted would contribute to the uplifting of corporate performance in the long run. The more

favourable argument will be that the protection of minority shareholders does not fall squarely on the verge of superior corporate performance as the fate of minority shareholders does rely heavily on strict corporate conformance to corporate best practices. For while superior corporate performance is certainly important, it is only fully realisable if corporations also strive for good conformance to the governance best practices. In the end, the numbers and statistics of a good or bad corporate performance merely act as a stimulant or poison pill for public listed companies at the mercy of the capital market. Although the theoretical discussion on corporate governance is abundant in the realm of Malaysian corporate framework, the findings of this study, when set against its research objectives, will have significant implications on improving the overall implementation of corporate governance practices in Malaysia with the aim to protect minority shareholders.

### **1.3 Objectives of Study**

The preliminary study reveals that good corporate governance is pivotal in protecting minority shareholders. Good corporate governance implies something more than shareholder democracy and the mere rights of shareholders to vote. These rights carry with it an obligation to participate, and in the case of shareholder activism, this obligation is to optimize shareholders' interests and management interests for mutual benefits of both to contribute to shareholder value. Ultimately, the integrity, credibility and efficiency of the market place count for investor confidence as the cornerstone of shareholder activism and protection of minority shareholders interest. Hence, the main objectives of this study are to pursue good corporate governance and to protect minority shareholders. There is an ardent need in employing high standards of corporate governance to secure investors' trust and confidence for a healthy functioning of

Malaysian capital market. This is because frank and transparent disclosure of procedures and policies must go beyond mere compliance on paper. The real test for good corporate governance is not just a matter of prescribing particular corporate structures for complying with the hard and fast rules. Real compliance is seen in corporate actions and practices that serve shareholders' interests.

The research objective in this dissertation is different from the existing literatures on corporate governance as its formulation of best practices is aimed at protecting minority shareholders, in particular. In essence, the objective of this study of corporate governance centres on the basis that minority shareholders most often seek to obtain from majority shareholders relate to the ability to:-

- a) select and elect members to the board of directors;
- b) participate in the decision-making process of a corporation;
- c) influence the outcome of certain corporate actions;
- d) secure representative seats on the board; and
- e) play more active screening role over the activities and decision of the board of directors;

Currently, the Annual General Meetings (AGM) and Extraordinary General Meetings (EGM) are the only democratic forum for minority shareholders to voice their views or dissatisfactions. Some of them see themselves as in an odd role, while a significant number of them think that they contribute very little, in the form of sweat, toil, money, or even marginal interests, to the corporations in which they are investors. However, this democratic forum may not seem to be an effective governance measure for the protection of minority shareholders. The failure of implementation of corporate

governance best practices enables majority shareholders to acquire a domineering role in the implementation of the corporate decision process. As noted by Eisenberg (1969), the mala fide manoeuvre by a board over the apathy on the part of institutional shareholders has generated serious confusion for courts in defining a director's responsibility to corporations and shareholders. The fact that institutional shareholders still remain passive was reflected in 2011 Green Paper on the European Union corporate governance framework (Birkmose, Neville & Sorensen, 2011).

In a nutshell, this study seeks to formulate corporate governance best practices in order to protect minority shareholders. Considering the complexity of derivative actions and statutory minority remedies, all investors not in control of running the company, should see the need to be active and to set the right directions for their investments and bring effective reforms towards integrity and accountability in listed corporations. Corporations that perform effective checks on their internal controls actually outperform those with weak internal systems. Notably, an effective corporate governance and ethics are the best means to prevent a corporate scandal from occurring in the first place. Therefore, it is timely to highlight these concerns so that minority shareholders' grievances and disappointments can be adequately and satisfactorily addressed. Minority shareholders should have the 'teeth' to bite whenever their patience is over-tried or over-tested.

#### **1.4 Methodology of Study**

As the research objective of this dissertation is theoretical in nature, qualitative research methodology is adopted to review the existing literatures related with the corporate governance system and structure that promote best practices. Unlike most studies on

corporate governance issues in Malaysia and East Asian countries which are based on strong quantitative methodological focus and being scattered in numerous disciplines (Zahra & Pearce, 1989; McIntyre, Murphy & Mitchell, 2007), this study aims to provide a more in-depth legal insights and understanding of corporate governance practices, using qualitative and analytical study based approach. The qualitative methodology which is adopted in this dissertation is mainly premised on succinct discourse analyses and commentaries on the literatures available in order to identify sound governance mechanisms. This qualitative study will draw examination from a number of jurisdictions but focused on Malaysian public-listed corporations which involve the public shareholders at large. The methodology of this study aims at providing positive descriptive analysis of the corporate governance best practices for the purpose of minority shareholders' protection.

In essence, this study will adopt a two-tiered approach leading to the ends of this study. The first tier is a descriptive analysis which is aimed at exploring the current corporate governance structures and their effectiveness in protecting minority shareholders. As for the second tier, explanatory analyses will be applied to assess the extent to which various mechanisms and best practices are effective to create an all-inclusive golden parachute of corporate governance for minority shareholders against the poison pills of majority shareholders. It is hoped that the research methodology of this dissertation is able to shed some illuminating light upon a comprehensive set of corporate governance best practices in Malaysia. While there was some fine-tuning to the Malaysian corporate governance regime, the initial study reveals that the corporate governance reform was to a certain extent rather inadequate in light of the application of the corporate governance recommendations and regulations enforced in Malaysia. The fallacy of application lies in the fact that the existing "Anglo-American" model corporate governance code is



almost akin to the UK corporate governance code which comprises of differences in culture, environment and attitudes towards managing a corporation. Hence, a comparative analysis of the relevant regulations and codes of other regional jurisdictions will be conducted to formulate a set of corporate governance best practices that is tailor-made with the Malaysian corporate culture, environment and legal framework.

By the same token, the Malaysian corporate governance reform had undoubtedly contributed to years of corporate success before the credit crisis, yet this reform came into question following the crisis. Therefore, there is an ardent need for further investigation to revisit the corporate governance reform in Malaysia and whether it can play a significant role in protecting minority shareholders – an issue that necessitates critical scrutiny later in this dissertation. Nonetheless, it was not the aim of this dissertation to provide a detailed review of governance reforms in Malaysia. Suffice it to say that this study employs the qualitative analyses to critically examine the existing governance framework in order to evaluate whether minority shareholders are adequately protected as a result.

### **1.5 Limitations and Suggestions for Future Research**

This dissertation will only adopt qualitative analyses based on literature review and case studies given the nature of this study. Hence, it lacks the practicality of researched data collected from the primary source like surveys and field work observation. As a result, the implication of research findings made is limited since such corporate governance best practices are yet to be implemented and tested in the corporate world. Further analyses and discussions are required in order to test out the best practices of corporate

governance in the real corporate environment. Be that as it may, Kueppers (2010) believed that “companies must find the implementation solutions that are most appropriate for their investors, management, board and other stakeholders, given the company’s current circumstances”. Without effective implementation of such best practices, minority shareholders will remain weakly protected.

On top of that, there are also other governance issues that require further research in order to provide a more detailed explanation for an effective implementation of best practices. For instance, one of the best practices mentioned in chapter 6 is that a board should allow shareholders to have more say in corporate strategic decisions and corporate governance related matters. However, future research may be helpful in providing further insights into the scope of such strategic decisions as well as the level of shareholder involvement in such governance matters so as to strike a balance between shareholder primacy and board primacy towards corporate primacy. It is also important for further studies to ensure that the best practices of shareholder activism do not unnecessarily encroach into the decision-making realm of the board and thus affecting the running of a corporation.

## **1.6 Conclusion**

Based on the above analyses, the literature review in this chapter sums up the need for the best practices of corporate governance to step in and act as the golden scale to complement the imperfection of law in balancing the rights of majority and minority shareholders with the holistic view of enhancing shareholder values. As an alternative remedy, the protective measure of corporate governance may help to prevent or avoid the occurrence of corporate malpractices. This chapter also discussed that any attempt to

reach a global code on corporate governance rests on doubtful foundation since ‘one size does not fit all’. In fact, the converse speaks volume of the reality that ‘one model does fit one corporation’. A well-designed corporate governance model based on widely accepted corporate governance principles will be the best policy for a particular corporation according to its distinctive nature of organisational functions, legal responsibilities and economic considerations.

Primarily, “corporate governance must no longer confine its analysis to the relationship between managers, boards and shareholders. The narrowness of this focus is a major contributing factor to the present round of corporate scandals of which Enron is the most emblematic” (Deakin 2003). Hence, a multidimensional approach to implement a set of governance best practices within a corporation is indispensable for recognising the many well-framed corporate governance principles that might reasonably enhance corporate functioning.

## **CHAPTER 2**

### **OVERVIEW OF CORPORATE GOVERNANCE PRINCIPLES**

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#### **2.1 Introduction**

This chapter will begin with the discussions on globalisation in a way that is useful to understanding the interplay between globalisation and the cross-national patterns of corporate governance in the age of turbulence. It will proceed to canvass on the various definitions and basic principles of corporate governance. It will review how corporate governance can and has been defined as well as its relevancy with corporate social responsibility. This chapter will also explore the reasons why corporate governance does matter and the justifications for having a sound corporate governance regime.

#### **2.2 Globalisation and Corporate Governance**

Corporate governance has over the years become a common parlance amongst the global corporate community. It is an art of term which witnessed its birth in the West, but has gradually gained increased significance in the East due to drastic evolvement of corporate governance systems led by corporate failures and systemic crises over the centuries. In the past few years, corporate scandals, environmental concerns and globalisation have all played their role in causing corporate stakeholders especially minority shareholders to query and consider how corporations should be governed.

The emphasis on good corporate governance practices is escalating as globalisation is liberalising the global markets with efforts being made to attract foreign investments.

International financial integration, cross-border trade and investment activities have led to many cross-border issues in corporate governance (Williamson, 1996). This also increases the importance of good corporate governance, but also makes it more complex, resulting in the clash of corporate governance practices and cultures that are at times uneasy. In relation to this, the 1997 Asian Financial Crisis is often cited as a catalyst for bringing corporate governance to the foreground since most corporations and regulators learn their lessons not from theories but from the historical age of turbulence. Since the beginning of new millennium, a rethinking of the existing corporate governance standards has been called for to establish the legitimacy and sustainability of globalisation.

The announcement on the liberalisation of many services sub-sectors by Prime Minister of Malaysia, Datuk Seri Najib Razak (*New Straits Times*, April 2009) will certainly become the driving force of globalisation for corporations to compete in a more liberal competitive market-economy. This bold revamp will also help to embrace corporate governance principles and best practices into an “evolving corporate behaviour and rationality” in the future. Most of us mistakenly share the view that globalisation means elimination of all barriers and differences – the promotion of homogeneity across the face of earth. Globalisation, however, is not a “bulldozer”; it is rather a global informational revolution which will not automatically wipe out all disparities and barricades between countries and communities. Thus, it is the thesis of this dissertation to propose a comprehensive set of corporate governance best practices which belongs to the unique identity of Malaysia’s own economic, cultural and legal landscape.

That said, it is not the focus of this chapter to discuss too much on the interplay between the world of globalisation and corporate governance. Suffice to say that while the past

decade has been spent to lay down the necessary foundation for corporate governance, the years ahead will see a pragmatic shift in the corporate agenda – an upward trend from mere corporate performance to strict corporate conformance with good corporate governance practices. This laudable process of globalised trend is thus labelled as “*corporalisation*” in the corporate world. Just as globalisation impacts the way financial markets are perceived all around the world, so too will it change the way in which we need to revisit some of the pertinent issues in corporate governance.

### **2.3 What is Corporate Governance?**

To formulate a set of corporate governance best practices, it should first be explained what exactly is meant by the concept of corporate governance. Though extensively used in theory and practice, the buzzword “corporate governance” defies easy definition. It is noted that there is no single definition for corporate governance. In its simplicity, Tricker (1984) described that “the origins of the word governance can be found in the Latin ‘*gubernare*’ meaning to rule or to steer”. He added that “the idea of steersman - the person at the helm - is a particularly helpful insight into the reality of governance”. In fact, the concept of corporate governance resists easy definition. It is not a static concept but continually evolving process of controlling management. However, corporate governance should be distinguished from the term “management” since it refers to the rules, regulations and best practices which ensure accountability, transparency and responsibility and not the day-to-day operation of business affairs (Darman, 2004).

According to the Report on Corporate Governance by the Malaysian High Level Finance Committee in 1999, corporate governance is defined as “the process and

structure used to direct and manage the business and affairs of the company towards enhancing business prosperity and corporate accountability with the ultimate objective of realising long term shareholder value, whilst taking into account the interests of other stakeholders”. A final analysis on the above definition reveals that the process and structure of corporate governance appear to be designed mainly to police corporate behaviour by various stakeholders. It is this external mechanism that is more likely to act as a “surveillance video” over corporate actions and decisions as opposed to those positive inspirational definitions that merely capture the enthusiasm of board and management.

Furthermore, the link between corporate governance and monitoring performance is clearly expressed in the definition stipulated by the Organisation for Economic Co-operation and Development (OECD) in 2004 which practically defines corporate governance as:

. . . the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance are determined.

The aforesaid authoritative functional definition expounded by OECD succinctly reflects the process and structure of corporate governance referred to in the Report on Corporate Governance by the High Level Finance Committee above. Both definitions

explain the division of power and accountability among shareholders, board and management, and its impact on other stakeholders such as employees, creditors including customers and suppliers, and community at large. It is widely acknowledged that there should be a set of rules and mechanisms to govern the process and structure of directing and managing the business and affairs of a corporation. Similarly, this explanation also shares the same spectacu-lars of key shareholder activists, Monks and Minow (2001) who defined corporate governance in its narrowest sense by limiting the primary participants in determining the direction of a corporation to shareholders, management, and board. Hence, corporate governance can also be viewed as a set of internal corporate arrangements which design the relationship between the owners and managers of a corporation. On the other hand, Sir Adrian Cadbury (2000) defined corporate governance, in its broadest sense, as “holding the balance between economic and social goals and between individual and communal goals”. He argued that “the governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources”. Regardless of the broadness or narrowness of these definitions, they share a common point that corporate governance is all about board responsibility and accountability in managing the relationship amongst the various stakeholders of the corporation.

Further, corporate governance can also be defined from two other perspectives – the corporation’s perspective and the public policy perspectives. From the standpoint of a corporation, corporate governance is given major significance in relation to value maximisation subject to complying with the corporation’s legal, financial, contractual, and other obligations. In view of attaining durable sustained value for a corporation, this perspective emphasises the ability of a board to balance the interests of shareholders with those of other stakeholders – employees, customers, suppliers, investors and



communities. With respect to the public policy perspective, “corporate governance is about nurturing enterprises while ensuring accountability in the exercise of power and patronage by firms” (Iskander & Chamlou, 2000). Hence, it can be understood from these two perspectives that there are two distinct forces that co-exist in a structure of corporate governance vis-à-vis the internal forces which define the inter-correlation among the corporate key players and the external forces which include policy, legal, regulatory and market that oversee the corporate behaviour and performance.

Even though it is hardly possible to define its exact scope, corporate governance is a multidimensional concept due to its involvement of various stakeholders’ interests. This dissertation thus defines corporate governance in terms of the pillars of corporate governance code of best practices which cover the generic concepts of “external” and “internal” corporate governance. It strives to ensure that corporations exercise their responsibilities towards shareholders effectively and satisfactorily. The “external corporate governance” may be defined as governance based on the presence and roles of the key stakeholders – auditors, minority shareholders, institutional shareholders, independent directors and corporate players as well as related corporate monitoring mechanisms and risk management. The “internal corporate governance” seems to suggest that corporate governance may be built around corporate values, corporate culture, ethics and management strategy with the enforced grips of laws and regulations upon board functions and establishment of committees.

The foregoing discussions entail the many different definitions of corporate governance. Although the term “corporate governance” is oft used, yet it lacks a precise definition since it involves transparency and accountability which render it thorny, if not unfeasible to capture the process and structure of corporate governance. Legally

speaking, corporate governance defines the respective roles and responsibilities of corporate key players and their influence in steering the course of a corporation towards the zenith of quality modern corporate life. In term of the protection of minority shareholders, one thing is certain – all of these definitions invariably address the following central theme in this dissertation which illustrates corporate governance as: the fortified legal and regulatory backbone of a corporation which supports its core skeleton of enhanced interactions, accountable relationships and systemic monitored functionality between its well-built body that governs (the board and top management), its constant bloodstream that keeps it alive (contributors of capital), its running feet that administer (seniors managers and corporate counsel), its employed hands that toil (employees or workers), its vital eyes that monitor (Chief Governance Officer and independent auditors) and autonomous brain that decides (all key stakeholders that have vested interest and other parties that take part to varying degrees in the decision making process). In the final analysis, the entire physiology of this corporate anatomy will eventually spiritualise its soul (business prosperity and corporate accountability) that vitalise its heartbeat (long term shareholder value) in the long run.

### **2.3.1 Is a Definition Still Useful?**

Have we ever paused to ponder upon the words “corporate governance”? We may want to question the ordinary layman on the street who may sometimes dabble on stocks investment and it is most likely that the response will be a blurred stare or a cynical look. The aftermath of corporate scandals has not enlightened the ordinary investors about what corporate governance really stands for in reality nor the implication of corporate governance in the corporate world. It seems to them that the words “corporate

governance” serve no significance to their stocks investment since the share prices and the rate of return on their investments are their only concerns.

By the same token, the question whether the definitions of corporate governance are comprehensive, all-embracing or precise in every sense does not bring to us the significance of these definitions when it comes to the protection of minority shareholders. Corporate governance is all about effectiveness of mechanisms that minimise agency conflicts involving managers, with particular emphasis on the legal mechanisms that prevent managers from expropriating minority shareholders (Shleifer & Vishny, 1997). The most imperative concern here is how best corporate governance principles are derived from these compatible definitions in order to be effectively implemented upon a corporations.

In other words, implementing good corporate governance practices spell out that corporations have to practise transparency, accountability and integrity. Therefore, the formulation and implementation of corporate governance principles warrant a careful consideration by those championing the rights of minority shareholders in culling out the ultimate objectives behind all these definitions for a deep understanding of corporate governance principles based on these definitions would certainly be useful to formulate the gist of the chapters which follow.

### **2.3.2 Why Does Corporate Governance Matter?**

The collapse of high-profile corporate giants such as Enron, WorldCom and the recent case of Satyam rammed home like never before the importance of strong and ethical corporate governance. What used to occur silently behind closed boardroom doors is

now a matter of considerable public interest in light of the recent credit crisis which has highlighted some of the dilemmas of corporate governance. These scandals, however, are just manifestations of some structural reasons why corporate governance has become more crucial for economic development and well-being (Becht *et al.*, 2003).

Basically, the very question that springs into our minds – is good corporate governance, as a standalone principle, sufficient to placate stakeholders with a vested interest in a corporation or minority shareholders whose backs have been pushed against the scandalous wall at the spectre of fraud, mismanagement and unaccountability in the boardroom? Be that as it may, good corporate governance practices encourage a corporation to deliver the message of reliability, trustworthiness, efficiency and stability to all its stakeholders. Evidently, corporate governance does matter predominantly to the preservation of shareholder value when it has been proven that both before (Joh, 2003) and after (Mitton, 2002) the Asian financial crisis in 1997, Asian corporations that focused on sound corporate governance practices provided greater protection to shareholders, especially minority shareholders.

Mensah *et al.* (2003) view that corporate governance is one of the most effective means to reduce the occurrence of corporate corruption as well as creating “safeguards against corruption and mismanagement, while promoting fundamental values of a market economy in a democratic society”. Corruption is deemed to be the most-feared term in a corporation since it may trigger havoc to the stability of a corporation which would in turn cause catastrophic effect upon minority shareholders’ interest. It also drains corporations’ resources and erodes competitiveness driving away investors. In this regard, the world has witnessed many notorious corporate collapses due to fraud or corrupt practices by board and management. To make matter worse, the unethical act of

unscrupulous auditors who assist the deceitful board to bury their corrupt practices under the boardroom carpet has added salt to the corporate wound. These corporate malpractices can be evidenced from the classic examples of Enron and Transmile.

Better structures and processes of corporate governance improve the internal corporate decision-making for the purpose of long-term prosperity. In addition, it also enhances a corporation's access to domestic and international source of finance from public and private entities since higher market valuations are also accorded to well-governed companies when compared with those poorly governed corporations. For instance, corporations must improve governance in order to meet more stringent listing requirements set at international equity markets. Moreover, sound corporate governance is a source of competitive advantage and critical to economic and social progress (Iskander & Chamlou, 2000). The wider economic significance of corporate governance became apparent as can be seen from the statements of World Bank (2000) "good corporate governance is not only about its increasing importance to international investors but also its protection of domestic investors". Yet the better reason for heightened interest in corporate governance owes it to the present general sense that corporations must be well-governed if they are to do good to the larger picture of the economy and society. As James Wolfensohn, the former President of the World Bank put it, "the proper governance of companies will become as crucial to the world economy as the proper governing countries" (*CACG Guidelines, 1999*).

On the flip side of the same coin, the investors' confidence towards the fundamentals of the corporations may be strengthened through the close adherence of corporate best practices. The bottom line is that investors seek out corporations that have sound corporate governance structures. Indeed, McKinsey & Company (2002) conducted

“Global Investor Opinion Survey on Corporate Governance” which indicated that significant majority of investors are willing to pay a premium for the securities of a corporation which has good corporate governance practices and most of them prefer well-governed corporations as opposed to poorly-governed ones where these corporations have comparable financial performance. This survey provides an imperative insight into the relative importance of corporate governance best practices. They are inversely co-related with the perception that reflects the increased confidence of minority shareholders regarding the value of investment in a corporation which adopts the governance best practices. Therefore, regulators and corporations should take cue from these findings to improve their awareness and conceptual understanding of corporate governance, and perhaps more importantly, to implement such pragmatic corporate governance principles as are required to upgrade the standards thereof. Recognising the importance of good corporate governance, the ensuing section highlights the basic principles of corporate governance for the purpose of formulating corporate governance best practices in chapters 5 and 6.

### **2.3.3 Basic Principles of Good Corporate Governance**

Although the concept of corporate governance has been recognised in the past, the need for greater transparency and the idea of stricter accountability towards minority shareholders are seen to be mowed from the backbone of the trust that investors have in a corporation. The question remains – what exactly are good corporate governance principles? A simple definition would classify it as an environment where individuals in control of a corporation provide quality management to advance the corporate values in the interests of all shareholders, regardless of whether they are minority or majority shareholders. This dissertation recognises that it is the interests, and not the rights, of

minority shareholders that need to be given emphatic considerations as the rights conferred by law are rarely comprehensive enough to avoid the undermining of minority shareholders' legitimate interests. As for such legitimate interests, they are in fact consistent with the long-term interest of a corporation. Both shareholders and corporations are well-served when management achieves the corporate goals and preserves the value of their shareholdings through good corporate governance.

Good corporate governance strikes the same chord with the core principles of transparency, board accountability and shareholder rights which have long been seen as the “holy trinity” of sound corporate governance. It encompasses shareholders' rights, board independence, internal control, risk management and other guiding principles which will be consistently reflected throughout the discussions in this dissertation. Bearing in mind these principles, it will facilitate the formulation of corporate governance best practices. It is worth to note that the principles of good corporate governance are also intertwined with the concept of corporate social responsibility which has gradually gained its prominence nowadays.

#### **2.3.4 Corporate Governance and Corporate Social Responsibility**

In the 1930s, the early proponents on the idea of corporate social responsibility – Berle and Means (1932) opined that a modern corporation should be a “social institution” involving an interrelation of a wide diversity of economic interests. This idea requires corporate restructure in order to include social policies within the financial structure of the corporate activities (Sheikh, 1996). Bursa Malaysia clearly defined corporate social responsibility as “open and transparent business practices that are based on ethical

values and respect for the community, employees, the environment, shareholders and other stakeholders. It is designed to deliver sustainable value to society at large”<sup>7</sup>.

The broadness of corporate social responsibility, though sometimes at its advantage, has also been seen as its major drawback, as the often-cited criticism by Votaw (1973) illustrated that “to some it conveys the idea of legal responsibility or liability; to others it means socially responsible behaviour in an ethical sense; to still others, the meaning transmitted is that of ‘responsible for’, in a causal mode; many simply equate it with a charitable contribution.” Hence, it means differently to different people due to its wide range of responsibility involving the society at large. Perhaps, it is hard to ignore the definition explained by Schreck (2009) that “definitions of corporate social responsibility lies the idea that actions and decisions by a company do not only concern its own interests but also those of society as a whole, or in economic terms: companies should internalise negative external effects”. In other words, corporate social responsibility requires directors to adhere to best practices that promote the interest of the public at large apart from shareholders and investors.

In a similar vein, corporate social responsibility should not be perceived as a mere corporate philanthropy which touches on poverty and woes of mankind. It has been irretrievably linked with good corporate governance practices that add value to a corporation. As correctly pointed out by Cheah (2008) – “are not these two good ‘fellows’ sharing the same bed of ethical practices leading to a high valued corporation”? It is viewed that corporate governance and corporate social responsibility do converge in the same bed of business ethics and good financial reporting system. For instance, corporate social responsibility manifested the reporting initiative of “triple bottom line”

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<sup>7</sup> Bursa Malaysia. *Corporate social responsibility (CSR) framework for Malaysian public listed companies*. Retrieved March 2, 2009, from <http://www.klse.com.my>



reporting which is designed to highlight the view that the financial bottom line is inadequate in measuring corporate success (Dechow & Skinner 2000). It is argued that equal consideration should be given to the social impacts and the environmental impacts arising from the corporate engagement with its daily affairs. This “triple bottom line” reporting constitutes an alternative means of avoiding reporting irregularities since financial success relies on the economic, social as well as environmental sustainability.

In the past, good corporate governance and corporate social responsibility had little to do with each other. The growing activism of minority shareholders, however, has recognised that corporate governance must be encouraged as it is one of the drivers behind the prevalent enthusiasm amongst corporations to assume greater corporate social responsibility. Nonetheless, a clear demarcation line should be drawn between the notion of corporate social responsibility and that of corporate governance obligation. The former has been described in the sense that corporate stakeholders should be advocating corporations to incorporate social responsibility into their corporate governance structure. It moves beyond the realm of corporate governance principles to include corporate commitments to publicise their responsibilities and explain to stakeholders how they are allaying concerns. Focusing on the legal aspect, this means that “social responsibility begins where the law ends. A firm is not being socially responsible if it merely complies with the minimum requirements of the law, because this is what any good citizen would do” (Davis, 1973). Broadly speaking, corporate social responsibility is viewed as transcending beyond fulfilling corporate governance obligations. On the contrary, the latter merely requires corporations to be law-abiding corporate citizens with regard to law and regulatory compliance. Due to the main objectives of this dissertation, the discussion of corporate social responsibility is not part of further analysis.

## **2.4 Conclusion**

Last but not least, this chapter makes a final note that corporate governance does matter in protecting minority shareholders. Good corporate governance principle goes in tandem with the rights and powers of shareholders which will be eventually translated into corporate governance best practices.

## **CHAPTER 3**

### **MALAYSIAN CORPORATE GOVERNANCE REFORM**

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#### **3.1 Introduction**

This chapter will review the reforms and measures introduced thus far to enhance the level of corporate governance in Malaysia. In essence, this chapter will highlight the roles and functions of various corporate governance regulatory regimes and stakeholders. Reviews are made on such corporate governance reform to identify the regulatory defects. The aim is to evaluate the extent of which these regulatory reforms have been effective in safeguarding the interest of minority shareholders. The shortcomings or defects, if any, will be underscored so that improvements can be made to the existing corporate governance regime.

It is also necessary to briefly examine the existing literatures addressing development of corporate governance best practices in other jurisdictions in order to assist in formulating the corporate governance best practices for the protection of minority shareholders. Last but not least, this chapter concludes the discussion by reaffirming the need to have a new set of corporate governance best practices that will be formulated in chapter 5 and 6 of this dissertation.

#### **3.2 A Review of the Corporate Governance Reform in Malaysia**

The catalyst for corporate governance reform in Malaysia was the Asian financial crisis in 1997/1998 (Ho & Wong, 2001). As a result, various regulatory reforms were

undertaken in the corporate governance regime. The push for corporate governance reform also calls for institutional and minority shareholders to participate more actively in the process of decision making and governing the corporations with higher transparency as well as wider accountability. Hence, the ensuing sub-sections will examine the corporate governance reform in Malaysia since 1997 in order to highlight the loopholes in the governance framework. Such identified defects are pivotal in setting the path towards the formulation of governance best practices in chapter 5 and 6 of this dissertation.

### **3.2.1 Regulatory Effort in the Corporate Governance Development**

When Malaysian regulators started to acknowledge the fact that poor corporate governance is one of the major factors leading to economy meltdown in 1997/1998, the High Level Finance Committee (“the Committee”) in its Report on Corporate Governance (“the Report”), has among others, introduced the Malaysian Code of Corporate Governance (Finance Committee on Corporate Governance, 2000) and 70 recommendations in March 2000 to deal with the corporate governance issues. The Malaysian Code on Corporate Governance introduced by the High Level Finance Committee was subsequently revised on 1 October 2007 (“the Code”). The Code has brought significant amendments that focused on the duties and responsibilities of nominating committee and board of directors, the composition of audit committees for the enhancement of corporate governance framework in Malaysia.

In essence, the Revised Code spells out the important principles and best practices on corporate governance structures and systems that corporations may adopt in their governance framework. It has also created some corporate governance principles and

best practices which are explained in the Revised Code's explanatory notes with the aim to attain the finest corporate governance framework. The Revised Code also reflects, amongst others, the importance of independence of nominating and audit committee as the former plays a vital role for board of director's appointment and reappointment whilst the latter acts as an effective check and balance on corporate financial status. For instance, it is required that corporation shall maintain a minimum one-third of independent non-executive directors in its composition of board of directors. Moreover, the Revised Code also stresses on the internal audit mechanisms within a corporation which have emerged as an important means to filter and report any corporate malpractices at an early stage.

Apart from the Revised Code, the Report has also brought to the establishment of the Minority Shareholder Watchdog Group ("MSWG") in August 2000. It is a non-profit company limited by guarantee which comprises of government-linked institutional investment funds as its founding members. One of its corporate objectives is to advise its members on issues of corporate governance, particularly those pertaining to the rights of minority shareholders. To improve corporate governance performance, Bursa Malaysia has also launched a Corporate Governance Guide together with the MSWG's implementation of a Malaysian Corporate Governance Index and Awards on 10 June 2009. The Corporate Governance Guide is intended to provide guidelines to corporate boards and managements on how to practise good corporate governance instead of the normal box-ticking approach. On the other hand, the Malaysian Corporate Governance Index and Awards are designed to enhance corporate governance best practices and to recognise good corporate governance practices amongst the public listed corporations in Malaysia. It "will provide a reliable gauge for investors to rate local public listed firms based on their level of adhering to globally accepted corporate governance standards"

(*The Business Times Malaysia*, 10 June 2009). The top 100 corporations would be measured in-depth and will be ranked based on corporate governance conformance, financial performance and corporate engagement.

This new initiative made by MSWG marked a new era of rating corporate standard in Malaysia. This new measure will in turn help to track corporations that do not comply with the mandatory disclosure requirements at an early phase in terms of corporate governance standards. The Chief Executive Officer of Bursa Malaysia, Datuk Yusli Mohamed Yusoff supported the MSWG's extended efforts to gauge the corporate governance performance of corporations beyond the mere box-ticking approach as shown in their annual reports. He remarked that there will be a shift from form to substance if the corporate governance issues pertaining to shareholders' rights and board accountability are adequately addressed in the daily operation of a corporation (New Straits Times, June 10, 2009). Besides that, MSWG also played its active role in participating in the general meetings of corporations they invested. For instance, MMC Corp Bhd has proposed to buy the unprofitable Senai Airport Terminal Services Sdn Bhd for RM1.7billion in 2009. The transaction came to limelight since it involved related-party transaction in which both the corporations are controlled by Tan Sri Syed Mokhtar Al-Bukhary. Representing the voice of minority shareholders, the MSWG has played a useful role in intervening in the transaction concerned by demanding a second valuation from MMC Corp Bhd. The second valuation was necessary to determine whether the offer price was fair enough to minority shareholders or not.

In March 1998, the High Level Finance Committee on Corporate Governance also set up the Malaysian Institute of Corporate Governance (MICG). It is a non-profit public company limited by guarantee, with founding members consisting of the Federation of

Public Listed Companies (FPLC), Malaysian Institute of Accountants (MIA), Malaysian Association of Certified Public Accountants (MICPA), Malaysian Institute of Chartered Secretaries and Administrators (MAICSA) and Malaysian Institute of Directors (MID). The MICG was established, amongst others, to assist the development of corporate governance in Malaysia and to tailor the governance practices to suit the needs of the local corporate arena (Dato' Shahraili Abdul Munid, 2006). In view of the importance of high quality accounting standard and reporting in corporate governance, the Malaysian Accounting Standards Board (MASB) was also established in March 1997 via the Financial Reporting Act 1997 as the sole authority to set accounting standards for Malaysia. It reviews and develops accounting and reporting standards based on the international best accounting practices and standards.

On 1 August 2009, the Companies Commission of Malaysia also teamed up with the Malaysian Institute of Integrity to promote both common interests in “increasing cooperation and collaboration on areas relating to corporate integrity, business ethics, corporate governance and corporate social responsibility” (*New Straits Times*, 1 August 2009). It is understood that the Training Academy under the Companies Commission of Malaysia will also organise “joint education and training programmes such as curriculum development, module design and learning interventions”. This initiative can be seen as part of the regulator's effort to cultivate awareness on the importance of good corporate governance practices amongst corporations through enhancing the corporate learning curve.

With regard to mandatory regulatory framework on corporate governance, it is worth to take into account the Companies Act 1965 which was amended on 23<sup>rd</sup> May 2007 via the Companies (Amendment) Act 2007 with the aim of uplifting the corporate

governance standards in Malaysia. The amendments, amongst others, include the insertion of new Section 131A into the Companies Act 1965 which prohibits a director of a public company or subsidiary company of a public company who has an interest in a contract entered into or proposed to be entered into by the company from voting on, or participating in the discussion on, the contract or proposed contract while the contract or proposed contract is being discussed in the meeting of board of directors. The amendments made to Section 132 of Companies Act 1965 have also further amplified the duties and responsibilities of corporate directors.

On the other hand, Section 132E of the Companies Act 1965 was amended to prohibit a company from carrying into effect any arrangement or transaction where a director or substantial shareholder of the company or its holding company or person connected with such director or substantial shareholder acquires from or dispose to the company shares or non-cash assets of a requisite value. Moreover, the amended Section 134 of the Companies Act 1965 also obliges directors to disclose the interests of their spouses or children which include adopted children and stepchildren as part of their disclosure of interest in the corporation. The preceding amendments are intended to enhance the governing laws on related-party transactions and corporate disclosure requirements.

As for the holdings of corporate meetings, Section 145 of the Companies Act 1965 was amended to the effect that public company shall issue the notice to call for its annual general meeting to its members not less than 21 days prior to the scheduled meeting. It is believed that this will provide reasonable opportunities to all shareholders to prepare for the meeting. This provision is further enhanced by the introduction of new Section 145A of the Companies Act 1965 which allows a corporation to hold shareholders'



meeting at various venues through the utilisation of modern information communication technology.

Another important amendment of the Companies Act 1965 covers the provisions on whistleblowers which impose mandatory obligation upon an auditor of public corporation to report to the Companies Commissioner of Malaysia any serious offence involving fraud or dishonesty that he or she has a reason to believe has been committed by any officer or employee of a corporation. In this regard, the auditors who have unravelled and reported the fraudulent offence in the performance of their legal duties and in good faith are fully protected by Section 174A of Companies Act 1965 against any court or disciplinary proceedings. This amendment seeks to shield the bona fide auditors from being persecuted for whistle blowing the corporations which they are engaged to audit.

As part of the latest regulatory effort, the Capital Market Services Act 2007 was amended in 2010 to enhance the enforcement powers of the Securities Commission against a director or officer who has committed corporate crime or securities offences which in turn caused a wrongful loss to a public listed corporation or its subsidiary to the detriment of shareholders of the public listed corporation. Through the new amendments, a new offence was created to forbid any person from influencing, coercing or misleading any person engaged in the preparation or audit of financial statements of a public listed corporation. Besides that, an independent Auditor Oversight Board was also established via the amendments to the Securities Commission Act 1993. These amendments are commendable since it goes in line with the “Malaysia’s regulatory objectives of fair and orderly markets, transparency, financial soundness and investor protection” (*The Business Times Malaysia*, 30 June 2009).

As the Malaysian economy continues to resist the global financial crisis in the 21<sup>st</sup> century, the belligerence of regulators' efforts towards development of better corporate governance reflects that a higher level of corporate governance conformance and performance is required. Such legal moves necessitate the right attitude and behaviour among the corporate industry to reach the next level of corporate governance standards in Malaysia. It follows that the impacts of such reform on the local corporate performance should be accessed in order to point out any regulatory gap that hinders the effective implementation of corporate governance best practices.

### **3.2.2 Corporate Governance Performance and its Regulatory Gaps in Comparison with Other Countries**

With the proliferation of regulatory efforts in improving the corporate governance standard, it is then important to shed light on the impact of corporate governance reform on the corporate governance performance in Malaysia. Sang-Woo Nam and Il Chong Nam (2004) found in their questionnaire surveys that “the gap between the regulatory framework and formal corporate governance practices is probably not particularly large, but that a substantial gap exists between the regulatory framework and practices in substance or spirit”. Hence, in accessing the corporate governance performance from the Malaysia's experience, it is necessary to discuss whether the substantial gap between the regulatory framework and corporate governance practices in Malaysia has been bridged by the regulatory reforms made by the local regulators and relevant agencies.

According to the *CG Watch 2007* report issued by the investment firm, CLSA Asia-Pacific Markets in collaboration with the Hong Kong-based Asian Corporate Governance Association (ACGA)<sup>8</sup>, Malaysia was ranked in the sixth position among 11 Asian countries for its corporate governance ranking based on issues such as rules and practices, enforcement, accounting, governance culture and political and regulatory environment. Notably, the report observed that the corporate governance landscape in Asia has “generally been on an improving trend” despite the fact that many Asian governments, regulators and market participants were growing complacent about the need for further corporate governance reforms.

However, ACGA’s secretary-general, Jamie Allen criticised the slower pace of corporate governance reform around the region where some regulators have even “taken their eye off the governance ball”. Specific attention was also drawn to the local corporate scandal of Transmile’s accounting fraud which stood as a chapter itself in the report – “Malaysia – Transmile testing the market”. The report further stated that “we have not noticed a significant step-change and the market hit some serious potholes when Transmile’s accounting irregularities came to the fore” in 2007. This report indicated that Malaysia has not fared well in the recent corporate governance performance as can be seen from its poor ranking compared with its counterparts in the Asia region. It was explained in the report that the poor ranking was partly due to the tightened scoring process and more focus was given to corporate compliance with corporate governance rules and best practices.

In April 2009, Chief Executive Officer of Securities Industry Development Corp (SIDC), John Zinkin has scathing criticisms against the Malaysia’s legal framework for

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<sup>8</sup> CG Watch. (2007). Corporate governance in Asia, CLSA Asia Pacific markets in collaboration with the Asian Corporate Governance Association. *Regional Special Report*.

corporate governance which has slithered behind most developed countries and even some emerging markets in the last four years. It was said that the fall began in 2005 “when directors of listed companies were no longer mandated to attend continuous training on a regular basis”. This phenomenon occurred when Bursa Malaysia removed the mandatory requirements of accreditation programme (MAP) and continuing education programme (CEP) for corporate directors of listed corporations in January 2005 as a result of the demands for its removal from the corporate sector. The board of directors of public listed corporations were then given the sole discretion to decide on the needs of continuous specific training for their directors. Consequently, it will put a stop on the “momentum for corporate governance excellence” which in turn has caused other nations outshined Malaysia in terms of the best corporate governance system (*The New Straits Times*, 27 April 2009). This faded focus on corporate governance was supported when PricewaterhouseCoopers Executive Chairman, Datuk Johan Raslan said that: “I noticed that when the Code of Corporate Governance came out in 2000, there was a heightened understanding of all the CG concepts. I think it has gone down” (*The Star Online*, Saturday April 25, 2009). As such, it can be seen that the focus on corporate governance has been waning in terms of compliance with the governance best practices.

Similarly, the USA also introduced the Sarbanes Oxley Act 2002 in the wake of the infamous Enron and WorldCom scandals. Due to the extensive discussions on the regulatory reform in the crisis-hit Asian countries (ADB 2000, 2001), it is best to comprehend the level of corporate governance conformance and performance in Malaysia by examining how corporate governance systems in other jurisdictions address the same issues. It aims to address these issues via brief comparative studies on the corporate governance systems and structures in other jurisdictions since corporate

governance developments in these jurisdictions like USA and UK often serve as a useful guide to local corporate governance reform. Despite the abundance of descriptive explanation contained in the existing literatures by scholars around the globe, the test for corporate governance issues lies in finding the defining line to explain the diverse corporate governance structures and systems. This defining line is in tandem with the importance of ownership concentration as one of the key ingredients of corporate governance (Schleifer & Vishny, 1997).

Generally, there are two ownership patterns: ownership type (who owns corporations: families, State or government, financial institutions, individuals, institutional investors, etc.) and how much they own (majority or dispersed ownership). The ownership structure of Malaysian corporations tends to be highly concentrated in the hands of a relatively small number of individuals, families and State enterprises (Shim, 2006). Comparatively, the corporate governance system in Malaysia is premised on the market-based governance model or Anglo-American system to a large extent (Liew, 2007). The Anglo-American system is classified as “dispersed ownership expecting short term returns, strong shareholder rights, arm's length creditors financing through equity, active markets for corporate control, and flexible labour markets” (Aguilera et al., 2004). Sang-Woo Nam and Il Chong Nam (2004) argued that “in companies controlled by family owners, these owners could pursue their private interests relatively easily and often at the expense of minority shareholders and firms’ profits”. It is noted that the high concentration of shareholding can lead to poor corporate governance as a small group can exercise control over a corporation and pursue the objectives of the insiders at the cost of the outsiders or minority shareholders (Claessens, Djankov, Fan & Lang, 1999).

In contrast, the corporate governance system in Continental Europe as demonstrated by Germany and Japan focuses on “long-term debt finance, ownership by large blockholders, weak markets for corporate control, and rigid labour markets” (Aguilera, 2005). Large shareholders, often, referred as block shareholders can benefit minority shareholders because of their power and incentive to prevent expropriation (Mitton, 2002). Due to the ample literatures and discussions on the corporate ownership structures (Bebchuk et al., 1999; Ayoib et al., 2003; Chen & Ho, 2000; Fan & Wong, 2002; Lemmon & Lins, 2001), suffice it to say here that the differences in these areas like the ownership structures, institutional and socio-cultural norms have thus accounted for some of the notable differences in the corporate governance models and regulatory framework found on either side of the Atlantic.

Basically, the regulatory framework for corporate governance in Malaysia has adopted the hybrid approach where there are mandatory regulations like securities laws, Companies Act 1965 and Bursa Securities Listing Requirements which comes into force in June 2001 as well as voluntary self-regulation like the Revised Code. However, this dissertation does not wish to delve deeply into the distinctive features and structures of the corporate governance models and regulatory framework in these jurisdictions. What is of major concern here is the discussion on the “comply or explain” principle present in the UK’s Combined Code on Corporate Governance and Malaysia’s Revised Code.

Strictly speaking, the Revised Code requires corporations to comply with the provisions of the Code taking appropriate action whenever possible to secure compliance or explain why they have not complied. Paragraph 15.26 of the Bursa Malaysia Listing Requirements also mandates that a public listed corporation must include the “Corporate Governance Statement” in its annual report stating its compliance with the

Code. This includes “a narrative statement of how the listed issuer has applied the principles set out in Part 1 of the Code” and “a statement on the extent of compliance with the Best Practices in Corporate Governance set out of the Code in Part 2 of the Code which statement shall specifically identify and give reasons for any areas of non compliance with Part 2 and the alternatives to the Best Practices adopted by the listed issuer, if any” (Practice Note No 9/2001, Bursa Malaysia Securities Bhd)<sup>9</sup>. The Revised Code thus emulates the UK tradition of “voluntary” compliance rather than legal enforcement.

Although Abdul Hadi et al. (2005) viewed that the aforesaid requirements would encourage corporations to be more transparent and accountable in their actions, the insufficiency of regulatory enforcement and monitoring of “comply or explain” principle has induced bad corporate practices, namely misleading financial statements, fraudulent share manipulation, non-transparent corporate policy, blatant disregard of minority shareholders’ interests in decision making process, non-conformity with the “comply or explain” principle and boilerplate disclosures. This boilerplate or “cut and paste” approach refers to the common use of standard template to disclose the corporate governance practices in their “Corporate Governance Statement” (Salleh Hassan & Bala Ramasamy, 2005).

Notably, some corporations have even tried to circumvent the “comply or explain” principle by merely complying with selective best practices that are favourable to them whilst leaving aside the rest without valid explanation or reason. This is partly due to the fact that most of the corporations in Malaysia still confine the notion of “comply or explain” to a mere compliance component in corporate governance regime. They do not

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<sup>9</sup> Bursas Malaysia Securities Bhd. *Disclosure in relation to the Malaysian Code on Corporate Governance and the state of internal control*. Practice Note No 9/2001.

perceive the notion beyond the realm of mechanical compliance in which the primary objectives of corporate governance are to enhance corporate performance and to preserve shareholder value, in particular, to safeguard minority shareholders' interests. Hence, the principle of "comply or explain" is merely a basis of regulatory action at corporate level. In practice, unless and until this principle is subject to some form of enforcement, it might remain a buzz phrase – an inchoate concept. In the absence of legal obligations and sanctions, it is highly likely that most corporations would not comply with the best corporate governance practices whilst opting not to explain such non-compliance at the same time. This is because it is hard to ensure that corporations would subscribe whole-heartedly to the principles of corporate governance when there is no proper enforcement or monitoring mechanism being put in place.

By the same token, one may reach the converse finding and argue that corporations in Malaysia would be over-regulated if more legal implications are attached with the corporate governance rules and practices. This view will lead to the conclusion that the restricted "comply or explain" self-regulation found in the United Kingdom's corporate governance system is nearer to optimal since it provides rooms for corporations to manoeuvre their business activities. Be that as it may, this conclusion does not truly reflect the 'public interest' hypothesis. The issue of over-regulation of corporate perpetrators would not arise at all when it comes to the larger picture of public shareholders – largely comprise of institutional and minority shareholders. It could be reasonably justified under the notion that public interest shall prevail over individual corporate interest to the extent that it would enhance corporate governance by protecting the rights of minority shareholders.



Apart from the “comply or explain” principle, this sub-section wishes to point out the defects in the Revised Code since its provisions are silent on certain important principles relating to good corporate governance. For instance, the Revised Code does not touch on the dividends paid out to the corporate directors – executive remuneration that intertwined closely with the other significant areas of corporate governance regime. It only provides a short explanation on the level and composition of remuneration, procedure and disclosure. In contrast, serious attention is given to the executive compensation within corporate governance framework in other jurisdictions such as in the United States of America (“USA”) and United Kingdom (“UK”). Unlike the Revised Code in Malaysia, the Securities and Exchange Commission of USA details out comprehensive guidelines on remuneration under their Compensation and Related Party Disclosure report. Hence, it should be borne in mind that the latest corporate governance developments could be superficial when the implications of the amendments to the Revised Code are yet to be seen in view of the recent economic turmoil. This dissertation suggests that the Revised Code should be given a fresh facelift rather than simply revamped in a piecemeal fashion. Such fresh facelift meant is addressed in the formulation of the best practices in chapters 5 and 6.

In this regard, the significance of corporate governance is widely acknowledged in Malaysia but the extent to which it has infiltrated the nation’s corporate culture remains limited and clouded. The beginning of 21<sup>st</sup> century has also witnessed a vigorous start on revamping corporate governance while losing its force of implementation over the past few years. Even if Malaysia’s corporate governance performance is showing some improving signs, regulators should neither be positively complacent about their achievements in the past few years nor be proudly contended with the rising corporate governance standards. Moreover, regulators should not be contended with the existing

corporate governance performance by declaring their reformatory efforts a success in the corporate governance landscape.

It is granted that there will never be a flawless regulatory regime for corporate governance in this world. It is simply because corporate governance reform requires continuing improvement to corporate governance practices. Corporate initiatives to improve corporate governance performance should not be made for the sake of corporate compliance per se. Rather, regulators should endeavour to further refine the existing corporate governance rules and practices in order to enhance the effective implementation of corporate governance best practices within the corporations. For this, Malaysia, as a developing country, will have to tail closely behind the corporate governance reform and recent developments in those developed countries.

### **3.3 Protection of Minority Shareholders under the Malaysian Corporate Governance Regime**

To further evaluate the corporate governance performance in Malaysia, it is imperative to examine the level of protection accorded to minority shareholders under the existing corporate governance regime since the protection of minority shareholders was one of the major issues addressed in the revised principles of corporate governance by OECD in 2004. This move reflects the importance of taking into consideration the level of protection granted to minority shareholders when the regulators are drafting the laws and regulations on corporate governance principles. It is also the main objective of this dissertation to address the protection of minority shareholders via the corporate governance best practices. The focus on shareholder rights and remedies is mainly formed by the prevalent sentiment of sympathy for vulnerable minority shareholders

whose interests had been compromised by those who control and manage corporations. The oppression by majority is often seen in various forms, including asset injections and disposals based on questionable valuations, inopportune share buybacks, and offer of corporate takeovers that minorities are forced to accept as well as excessive executive remuneration and share options for directors.

Recently, Malaysia was ranked in the fourth position overall for protecting investors by the World Bank (2009) in its report on Doing Business 2009<sup>10</sup> which measured the strength of investor protection index in Malaysia based on its extent of disclosure index, director liability and the ease of shareholder suits. It is observed that the adequacy of minority protection in Malaysia – which is equivalent to the World Bank’s investor protection terms, are scrutinised in the context of the rights accorded to shareholders as a whole, the transparency level of the disclosure requirements as well as the effectiveness of legal enforcement against share manipulation and oppression upon minority shareholders. Although the above finding has indicated that the legal protection of minority shareholder rights and the regulatory framework in Malaysia appeared comprehensive and were relatively adequate compared with other countries in their study, the main corporate governance issue here is whether the interests of minority shareholders are sufficiently shielded in practice since majority of public listed corporations in Malaysia have controlling shareholders who dominate the management and the boardroom. Besides that, the ascending of shareholder activism from corporate scandals like that of Enron and Transmile has also given rise to the need for stricter enforcement of laws and regulations relating to shareholders’ protection. For instance, Asian countries supported these activations by introducing new laws and regulation that calls for better corporate governance such as, Singapore Rules 1998,

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<sup>10</sup> World Bank. (2009). *Doing business 2009 report on country profile Malaysia*. Washington: The World Bank.

Japan Code 1998, Thailand SET Guidelines 2001, Indonesia Code 1999, and Hong Kong Code 1993. Nonetheless, the issue arises as to whether the existing regulatory framework in Malaysia, including the Revised Code provides a solid platform to protect shareholders rights, in particular the rights of minority shareholders.

Furthermore, it is also crystal clear that corporate management and the majority shareholders are inclined to expropriate the rights of minority shareholders to safeguard their own interests. This is also consistent with the finding of La Porta, et al. (2000) that the protection of minority shareholders is weak in East Asian countries. Zuaini Ishak and Napier (2006) argued that the expropriation of minority interests might be intensified by high control rights of controlling owner through corporate diversification strategies. In this regard, it is pertinent to briefly examine how well minority shareholders' rights are protected by the existing laws in Malaysia in order to determine whether it is adequate to enhance such protection against fraud on minority in terms of corporate governance standards. In other words, the formulation of policy reform in Malaysian corporate governance regime should be extended to the cost-benefit consideration of minority rights and corporate interest, the harmonisation of corporate environment and the experiences from other jurisdictions as well.

### **3.3.1 Adequacy of Shareholder Rights and Remedies under the Regulatory Framework**

With regard to the adequacy of shareholders' rights, the Malaysian laws generally provide shareholders with right to vote in the annual general meetings of a corporation. These rights cover major corporate actions such as the dealings or related-party transactions affecting substantial portion of the corporate assets, key alterations made to

corporate constitution as well as the appointment or re-appointment of corporate directors. Indeed, Thillainathan (1998) propounded that the voting rights attached to the shares as well as the rights that support the voting mechanism have to be examined against the interference by the corporate insiders in order to evaluate how well Malaysia fares as regards the principal right of shareholders.

Pursuant to Section 128 of the Companies Act 1965, shareholders have the right to vote on the removal of corporate directors from their office by a resolution of a simple majority. Notwithstanding this shareholder right, CEOs or corporate management get to choose their own slate of directors whom they favour and nominate their names for election or re-election in the annual general meeting. Most often than not, this practice brings us to the reality that shareholders would rubber-stamp the appointment of directors themselves or through a proxy vote. Hence, one cannot find adequate check and balance on the eligibility and suitability of the corporate directors when shareholders' rights to vote are restrictive in nature. This is the reason why corporate governance performance in Malaysia has not attained the optimum level when compared with neighbouring countries in this region like Singapore and Hong Kong in the recent corporate governance performance assessment by the World Bank. Conversely, shareholders, particularly minority shareholders should have more than just rubber-stamped rights to vote for their choice of corporate directors in order to ensure that there is check and balance mechanism in the corporate governance performance of corporations.

Be that as it may, shareholders' rights to vote and elect their directors would at most serve limited purposes in the spirit of corporate governance since the inherent powers to manage and supervise the daily business affairs of the corporations reside in the hands

of directors pursuant to the new Section 131B of Companies Act 1965. Notwithstanding the legal requirements that directors have to exercise “best judgment rule” in managing and deciding their corporate actions, most often than not, board will normally pass a board resolution or circular to ratify the actions taken by directors. This phenomenon has given rise to conceptual anomalies pertaining to the effectiveness of shareholders rights as prescribed under the laws. In other words, shareholders may have the hypothetical right to vote for the appointment of directors whom they favour, but neither are they given the complete oversight of the corporate actions taken by directors in the daily affairs of the corporations nor the power to direct the corporate management entrusted to the board of directors. To make matter worse, it seems that the corporate environment in Malaysia does not encourage minority shareholders to call for extraordinary shareholders’ meetings or allow them to table their issues on the corporate agenda of a shareholders’ meeting. Even if minority shareholders have the right to attend general meetings and other shareholders’ meetings, it does not necessarily imply that minority shareholders have sufficient voting powers to override or pass through a resolution due to the limited rights to vote as compared to majority shareholders who have more counts of votes in practical sense.

Nonetheless, the significance of the rights given to minority shareholders seems to be more visible in situations where shareholders have the power to remove directors before the expiration of their period of office by ordinary resolution and the power to amend corporate constitution by special resolution during corporate meetings under Sections 128 and 21 of Companies Act 1965 respectively. However, these shareholders’ rights are deemed to be of little impact on the corporate governance standards and practices in corporations. Firstly, it may be impractical for shareholders to exercise their rights to remove directors when the damages have been effected by the unfavourable transactions

since normally these transactions are discovered at a later stage. Secondly, the power to amend corporate constitution is limited to the extent of the compositions of voting rights minority shareholders have. Hence, they may not have sufficient power to thwart the decision made by board due to the aforesaid reasons.

Even though it seems that the establishment of the MSWG and its efforts may assist to change the fate of minority shareholders in Malaysia in the long run, it can be argued that MSWG, as a market institution which is supposed to promote shareholder activism may, at one point, find it difficult to strike a fine balance between the protection of minority interest as a whole and MSWG's shareholder interests in public-listed corporations. It is indisputable that MSWG was established to promote good corporate governance, but one may not rule out the possibility that they may contravene the corporate governance principles or best practices since they are no different from other shareholding investment corporate vehicles. This would eventually turn them into "the foxes that are guarding the henhouse" in view of the possible call for corporate governance reform within their own body. As such, it remains hard to have an independent non-corporate linked body to champion minority shareholders' interests.

In furtherance to the role of MSWG in upholding shareholder activism, the Employees Provident Fund (EPF), as a huge institutional investor in the Malaysian capital market, also acts as a key player in shaping the local corporate landscape. EPF has often taken the initiatives to pay corporate visit to corporations which it has substantial vested interest. Unlike MSWG, EPF is more driven by both institutional shareholder activism and corporate interest. This is due to its active participation in Annual General Meetings of these corporations in order to promote institutional shareholder activism which in turn helps to protect its corporate interest. One must not lose sight of the fact that EPF is

morally obliged to declare dividends to its members across the nation annually. Hence, it is still difficult to ascertain how much corporate governance performance that would be and has been improved by these market institutions.

As for the adequacy of remedies, it has become more and more manifest ever since the landmark case of *Foss v Harbottle*, that minority shareholders “hunger” for a sufficient degree of protection from the expropriation or oppression of majority shareholders who are often directors. Previously, Section 218 (1) of the Companies Act 1965 provides the only drastic remedy to petition for winding up of a corporation on “just and equitable” ground. However, winding up of a corporation is draconian in nature since it involves the dissolution of the whole corporate organisation and cease of business activities. Walter CM Woon’s Company Law at p 499 (as quoted in *Tien Ik Enterprises Sdn Bhd & Ors v. Woodsville Sdn Bhd* [1995]<sup>11</sup>) stated that:

When it is sought to invoke the court’s discretion to wind the company up, the fact that the petitioner has an alternative remedy is relevant. Thus if the petitioner is able to sell his shares at a reasonable price it would be more difficult to justify a winding up since he would not need the aid of the court to extricate his investment. Similarly, if the petitioner’s grievances can be redressed under s 216 (s 181 Malaysian Companies Act) a court should be reluctant to grant the rather draconian remedy of winding up.

This measure may not necessarily be the viable solution intended to be sought by minority shareholders, especially if a corporation is a profitable and fundamentally strong entity. Hence, it will normally be used as a last resort by minority shareholders

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<sup>11</sup> [1995] 1 LNS 99.



and the court when all other remedies have been exhausted. For this reason, it can be said that the remedy under Section 218 of the Companies Act 1965 may not be an effective and adequate remedy to address the grievance of minority shareholders.

In the final analysis, it can be said that minority shareholders' rights were often neglected in practice because of the excessive power enjoyed by controlling shareholders in the Malaysian corporate structure. This in turn implies that corporate governance reforms in Malaysia could contribute to enhanced legal protection for minority shareholders in the commonly family-dominated Malaysian corporations. In determining the adequacy of remedy, it is also vital to examine the statutory derivative right of minority shareholders in the event of expropriation by majority shareholders.

### **3.3.2 Statutory Derivative Action in Relation to the Protection of Minority Shareholders**

In *Wallersteiner v Moir* (No.2)<sup>12</sup>, Lord Denning explicitly described derivative action as an action brought by an individual shareholder on behalf of himself and other members except the wrongdoers to remedy a wrong done to a corporation and which cannot otherwise be corrected because of the reluctance or refusal of the majority wrongdoers to rectify the wrong. It is clear that this remedy falls broadly within the fraud on minority or established exception under the rule in *Foss v Harbottle* which stated that in respect of wrongs done to a corporation, "the corporation should sue in its own name and in its corporate character, or in the name of someone whom the law has appointed to be its representative". Under this exception, minority shareholders often met with

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<sup>12</sup> 1 All E. 849, 857.

bumpy path towards lawsuit against majority shareholders or directors simply because there are a few practical hitches hindering the process of minority's legal actions.

Firstly, minority shareholders are heavily burdened with the costs of initiating the proceeding in the name of corporation. Secondly, the courts have always give due consideration to the fact that the breach in issue has been ratified by board or in general meeting. Thirdly, they have no individual right to the prospective damages or monetary compensations that may be granted by the court since all these will be received by corporation as the complainant in the proceeding. Lastly, the powerlessness of minority shareholders to gain sufficient corporation information since the access to its flow is usually restricted by directors and management. On the other hand, majority shareholders who are largely comprise of the board in Malaysian public listed corporations tend to pursue their own corporate interest to the extent of jeopardising minority shareholders' values, particularly in situations of management buyout, delisting and mergers and acquisitions.

Taking cognisance of the aforesaid substantial difficulties faced by minority shareholders, the new Sections 181A and 181B of Companies Act 1965 have codified the right of shareholder's derivative action in common law into statutory right. The provisions stipulate that leave of the Court may be obtained by a member or any director to initiate proceedings or to intervene in proceedings on behalf of a company. Even if directors attempt to circumvent shareholders' action through the process of board ratification, the new Section 181D of Companies Act 1965 was inserted to allow the person who has the *locus standi* to bring an action under Section 181A of Companies Act 1965 notwithstanding that the ratification may be considered by the Court in reaching its judgment or granting orders.

It appears that the introduction of Section 181A of Companies Act 1965 has on the surface, eradicated the difficulties faced by minority shareholders to bring a suit against directors under the previous common law position set forth in the infamous case of *Foss v Harbottle*. Nonetheless, it remains unclear as to the factors taken into consideration by the Court in deciding whether or not to grant leave of application to sue pursuant to Section 181B of Companies Act 1965. The provision lays down the requirement that the complainant is acting in good faith and it appears *prima facie* to be in the best interest of a corporation that the application for leave be granted. This new introduction of statutory derivative action will allow courts to take into account essential factors such as the good faith of shareholders and the best interest of corporation, rather than whether a shareholder should be allowed to sue in the name of a corporation.

As for the requirement of good faith, the Singapore court in *Pang Yong Hock and another v. PKS Contracts Services Pte Ltd* [2004]<sup>13</sup> held that “the best way of demonstrating good faith is to show a legitimate claim which directors are unreasonably reluctant to pursue with the appropriate vigour or at all.” The fulfilment of the first requirement of good faith seems to reflect the second requirement of *prima facie* to be in the best interest of the company (*Ng Hoy Keong v. Chua Choon Yang* [2010]<sup>14</sup>). As can be seen in the case of *Mohd Shuaib Ishak v. Celcom (Malaysia) Bhd* [2008]<sup>15</sup>, the High Court ruled that “the complainant had to demonstrate that there was a reasonable basis for the complaint and that the proposed action was legitimate and arguable, in that it had a reasonable semblance of merit”. In that case, there was *prima facie* evidence that the proposed action by shareholders was in the best interest of the company as the

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<sup>13</sup> [2004] 3 SLR 1.

<sup>14</sup> [2010] 9 MLJ 145.

<sup>15</sup> [2008] 1 LNS 314.

breaches of directors' duties involved "self-serving behaviour which is culpable and at the expense of the corporate interest of the company as well as shareholders". However, the *Mohd Shuaib Ishak* case was overturned by the Court of Appeal which adopted a stricter interpretation of Section 181A. The Court of Appeal was of the view that the application of Section 181A must not run foul of the company's interest. In this regard, the pertinent issue remains that what constitute good faith of shareholders and best interest of a corporation are very much a subjective exercise of discretion by the Court as well as a mere conjecture by minority shareholders in such a derivative action suit.

Similarly, Choong and Sujata Balan (2008) agreed that "what remains to be done is for the courts to interpret these statutory provisions in a broad and liberal manner so as not to stifle actions by minority shareholders against the company's wrongdoers". Furthermore, Section 181A(4)(d) provides the Registrar the power to initiate a derivative action in the case of a declared company under Part IX of the Companies Act 1965. Although this new Section has opened up an alternative route to the enforcement path of the corporate regulators, it is clear that "the scope of powers conferred on the Registrar is quite limited" due to the reason that "securities market regulators in the US, the UK, Australia and Malaysia have been conferred with the authority to use civil proceedings to enforce any contravention of the securities laws" (Malaysia Corporate Reform Committee, December 2007). Despite such right to derivative action, it is also pertinent to point out that the legal protection afforded under Section 181 depends on how minority shareholders can satisfy the court that there is a total disregard to their interests or unfair discrimination against them. Minority shareholders would have to go through all the hassles to bring the court's attention to these "equitable considerations" when they feel that they have been sidelined, discriminated or treated unjustly. The

situation is made worse when minority shareholders do not even know each other or when they are disunited or totally disorganized among themselves.

In the upshot, the statutory derivative action often only acts as the remedial measures for minority shareholders during the aftermath of corporate scandal. Although it may save an individual minority shareholder from the onerous costs of proceedings, the new inclusion of statutory derivative right has not promised enhanced transparency and accountability of corporate directors in relation to higher corporate governance standard. Therefore, it is for the foregoing reasons that the positive effect of this new statutory derivative action is yet to be clearly visualised by minority shareholders in terms of the local corporate governance practice. Ultimately, the question of adequacy of minority protection is best answered in terms of preserving and enhancing shareholder values via the implementation of corporate governance best practices.

### **3.3.3 Preserving and Enhancing Shareholder Values**

In investment's term, shareholder value can be defined as the value that a shareholder is able to obtain from his/her investment in a corporation. This value is made up of capital gains, dividend payments, proceeds from shares buy back schemes and any other payout that a corporation might make to a shareholder. Shareholder value "can also be influenced by maximising economic value, either by undertaking positive present-value decisions or by running the business in such a way as to create a surplus above the market costs of funding" (Dictionary of Business and Management, 2006). The corporate governance reform analysis in this dissertation largely owes itself to a stream of high profile corporate collapses which have left shareholders with nothing but huge losses. Serious attention has to be drawn to how shareholder values are greatly

expropriated by the corporate management to attain individual ends, and thence to the question of how shareholder values can be enhanced in pursuance to the rights conferred by corporate law on shareholders. To do so, it requires a redefinition of the shareholder value. In the UK, the recent review of company law proposed that corporate boards should seek to achieve ‘enlightened shareholder value’ (Company Law Review Steering Committee, 2001)<sup>16</sup> which means that the interests of the different stakeholders should be balanced in such a way as to create closer collaboration amongst them in enhancing the long-term interests of shareholders.

In the context of enlightening minority shareholder values, it is interrelated with the notion of “shareholder activism”. Low (2004) defined “shareholder activism” as the exercise and enforcement of rights by minority shareholders with the objective of enhancing shareholder value over the long term. The Star Online (2009) reported in its business section that “shareholder activism is on the rise in Malaysia and could, in the longer term, positively affect companies to enhance shareholder value”. This was further supported by Rita Benoy Bushon, MSWG’s Chief Executive Officer that more retail shareholders are attending annual general meetings of corporations and posing relevant questions to the respective boards of directors (*The Star Online*, July 8, 2009). Selvarany Rasiah, Bursa Malaysia Bhd’s Chief Regulatory Officer also mentioned that “emphasis should also be placed on non-technical aspects of the profession such as improving negotiation as well as conflict mediator skills as such traits would certainly enhance their worth in the eyes of the board”. Hence, it is not wrong to say that the rising of shareholder activism may affect the corporation’s operating behaviour such as “alleviating boardroom complacency and bring about more positive changes towards enhancing shareholders’ value in a more timely manner” (*The Star Online*, July 8, 2009).

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<sup>16</sup> Company Law Review Steering Committee. (2001). *Modern company law for a competitive economy: Final report volume 1*. London: DTI.

However, it is interesting to note that corporations often undermine the need to enhance the shareholder value especially for minority shareholders when there is a conflict between shareholder value and corporate business objectives. The total investment holdings of minority shareholders are principally insignificant to the entire financial status of a corporation due to the relatively small quantum of shares held by minority shareholders in the corporation. As a result, it would create a wrongful perception amongst the corporate management that it is not important to preserve or enlighten minority shareholders' values. This is very much different from the case of employees and the benefits accrued to the majority shareholders. In the case of the employees, "they get paid almost immediately for their efforts, and are generally in a much better position to hold up the firm by threatening to quit than shareholders are" (Schleifer & Vishny, 1997). Hence, corporate governance best practices shall be formulated and implemented in such a way that directors will consider the best interest of a corporation to include minority shareholders. To fix this thorny issue, it is suggested that the corporate governance regime should be designed mainly to preserve the values of shareholders

### **3.4 Short Case Studies on the Corporate Scandals**

The lack of good corporate governance can lead to the aggravation of conflicting interests. Each of the substantial corporate stakeholders has the tendency of making decisions they believe will be favourable to them, even though, it does not seem to be equivalent to the best interest of other stakeholders. This means that different corporate members can assert their own views and perspectives. As such, a corporation will no longer function as one instead selfishly directed when the stench of fraud and

dishonesty reeks from corporations with poor corporate governance. These inferior qualities of corporate governance would eventually lead to corporations paying a higher price than they imagined.

Evidently, the collapse of many corporations was being attributed to poor corporate governance such as fraudulent financial statement, shares manipulation, corporate mismanagement and other illegal practices. These corporate scandals have brought negative repercussions to the corporations and stakeholders at large. For instance, the case studies below will uncover that the inflow of capital stopped and as such, the corporations crumbled when the investors became wary of the corporate illicit practices. The ensuing sub-sections discuss on the case studies of the Enron and Transmile scandals in order to find out the lessons that may be garnered in improving the corporate governance framework.

### **3.4.1 Enron**

As a global giant energy corporation in 2001, Enron unexpectedly shattered into pieces with the sharp decline in its share prices and filing of bankruptcy under Chapter 11 of the United States Bankruptcy Code. Wearing (2005) has analysed that the collapse of the Enron was very much attributed to the devious utilisation of the special purpose vehicles in creating misleading financial position, excessive executive remuneration in relation to its annual net income (Useem, 2003), ineffective board of directors and dependent audit committee. To make matter worse, the external auditors of Enron, Arthur Andersen had also illegally performed their auditing duties by shredding and erasing documents from the financial records for the mala fide purpose of financial misstatement (Squires et al., 2003). This unlawful act has eventually caused great



impact on the reliability and trustworthiness of Arthur Andersen which has then vanished from the auditing world.

Bob Garratt (2003) quoted an anonymous email which was circulated in 2002 on the Enron debacle as follows:

**“Normal capitalism:** you have two cows and buy a bull. Your herd multiplies and the economy grows. You sell the bull and retire.

**Enron capitalism:** you have two cows. You sell three of them to your publicly listed corporation, using letters of credit opened by your brother-in-law at the bank. You then execute a debt/equity swap with an associated general offer so that you get all four cows back, with tax exemption for five cows. The milk rights of the six cows are transferred via an intermediary to a Cayman Islands company, secretly owned by your chief financial officer, who then sells the rights for all seven cows back to your listed corporation. Your annual report states that your corporation owns eight cows, with an option on six more”.

The aforesaid comparison of normal and Enron capitalisms has clearly illustrated the complex modus operandi of the fraud and dishonesty experienced in the Enron scandal. It shows that Enron was once managed by a bunch of crooked and unscrupulous directors and managers who selfishly swindled the capital and wealth of a corporation through various deceitful conduit pipes and fraudulent financial report. The corporate malfeasance involved here was so different from the normal capitalism process where the assets or resources of a corporation are efficiently managed and utilised to generate income and capital flow for the purpose of business expansion. Unfortunately, the

relaxed corporate governance regulatory framework prior to 2002 has failed to prevent such disease from spreading into the corporate world of the USA. Only after this Enron scandal emerged that the USA's regulators realised the importance of strict regulation on corporate governance by enacting the new Sarbanes-Oxley Act 2002.

With regards to the Enron debacle, Deakin and Konzelmann (2003) viewed that "while board members may have been mistaken, with the benefit of hindsight, in waving through these deals, it does not necessarily follow that individual directors breached the duty of care they owed to the company; the protective 'business judgment rule' will protect them from liability for decisions taken in good faith". As such, the Enron scandal has also prompted the revisit of the business judgment rule which is further discussed in the ensuing chapters.

### **3.4.2 Transmile**

On 14 November 2007, the Securities Commission Malaysia has filed charges against two former directors of Transmile for intentionally authorising the submission of misleading financial statement to Bursa Malaysia Securities Berhad in relation to its "Quarterly Report on Unaudited Consolidated Results for the Financial Year Ended 31 Disember 2006". Both of the accused persons were former Independent Non-Executive Directors of Transmile.

The Securities Commission Malaysia claimed that they had the knowledge of the false statement when they authorised the statement for furnishing to Bursa Malaysia Securities Berhad. Notification was initially sent by Transmile to Bursa Malaysia informing that its auditors found it difficult to verify Transmile's financial accounts for

the year ended 31 December 2006 due to the absence of some documents. Moores Rowland Risk Management then conducted a special audit on Transmile's accounts and discovered that the revenue and assets of the company as reported in its financial statement had been blatantly inflated by way of deceitful invoicing.

Subsequently, much criticism had been thrown against Deloitte & Touche who was the external auditor of Transmile for not discharging their duties to audit effectively. The criticism was refuted by Deloitte & Touche that as an external auditor, it is almost unfeasible for auditors to check on every single transaction in the auditing process. Hence, external auditors would have to put heavy reliance on the internal management of a corporation to perform the task of corporate governance and to ensure that proper internal control systems are in place to detect accounting fraud.

### **3.4.3 Have We Not Learnt Our Lessons?**

From the preceding corporate scandals, those who have been championing for better corporate governance principles have been slapped with great impasse of corporate governance failures. These failures indicate that although good governance principles have been deeply embedded in the Western corporate culture, there is still a distant road ahead and ample room for improvement to produce exemplary benchmark of corporate governance practices in Malaysia. It is believed that no single party will stand out and bravely admit to bear all responsibilities when the outcries of corporate scandals start to point fingers at certain corporate culprits. For instance, Deloitte & Touche as the external auditor of Transmile has refuted the claims that they should be blamed for the accounting fraud in Transmile. Its Chief Executive Officer for Asia-Pacific, Chaly Mah

Chee Kheong argued that it was their “stringent audit process” that enabled them to unravel the accounting fraud in the corporation (The Malaysian Bar, 21 July 2007).

However, the accounting firm giant could have detected the slightest hint of corporate malpractice underlying the Transmile’s boardroom carpet at an early stage if they have practised stringent audit processes in the entire corporate governance system and adhered to the high standard of accounting standard. Although credits may be given to Deloitte & Touche for unravelling the accounting fraud, but it is their sacred duties to be alert with the abnormal accounting practices and financial performance of Transmile throughout their annual auditing process. In the event that they are suspicious of any fraudulent transaction shown by their auditing results, steps must be taken to report the case to the relevant authorities and regulators like Bursa Malaysia and the Securities Commission Malaysia. This prompt action is necessary for the purpose of giving an early opportunity to the relevant authorities to implement their monitoring mechanism on the financial operation of a corporation.

In this context, it would be a fallacy to argue that the external auditors could rely on the corporate management and board of directors in an audit process. As professional external auditors, they shoulder the responsibilities to audit which could not possibly be transferred to corporations in any given circumstance. After all, the function of an external auditor is to verify the financial accounts of a corporation for the purpose of check and balance. The independent function of the external auditors should not be confused with the internal auditing process which may be interfered by the corporate management. In the *Economist*, September 2002 (as cited in Deakin, 2003), it was learned that “companies need stronger non-executive directors, paid enough to devote proper attention to job; genuinely independent audit and remuneration committees;

more powerful internal auditors”. With respect to this particular lesson, Chapter 5 of this dissertation proposes various governance best practices that may strengthen the internal control system of a corporation through risk management and better auditing process.

The foregoing series of corporate scandals that shattered the confidence of investors and minority shareholders raise the question whether the regulators are ready to take extra miles to revive the lost investors’ confidence in the corporate world and market. Have we not learnt from our past bitter corporate experiences like the Transmile scandal that has become somewhat emblematic of the existing issue of corporate governance in Malaysia? In the event that we could not learn much from the local corporate scandal, perhaps the experiences in foreign corporate scandal may shed some invaluable light on the corporate lesson that we may learn from.

All in all, the corporate scandals have taught us that conspiracies by their nature do not reveal themselves to minority shareholders who will be left bearing the consequential losses. Perhaps the good lesson that has arisen out of these bad corporate experiences is the rising appreciation of the importance of good corporate governance practices amongst the larger community. The lessons learnt have also pressed for the need to comprehend and implement established and well-thought-out corporate governance principles and practices.

### **3.5 How to Fix Corporate Governance for Minority Interest?**

Corporate shenanigans are as antique as the existence of corporation itself. From corporate malfeasance to oppression against minority shareholders, corporate world has

long been tainted with unscrupulous corporate players who crave to reap immense wealth from business activities by not abiding by the laws and rules. As corporate governance marches steadily, such unhealthy corporate malpractices have gradually been weeded out by the regulators. Nevertheless, as the saying goes, ‘Old habit dies hard’. Corporate fraud and scam still find their ways to penetrate the regulator’s enforcement wall irrespective of the fact that the modern investors and minority shareholders are becoming more watchful of their own interests.

These corporate scandals, some of which are still unfolding, involving oppressive activities of directors and majority shareholders expropriating the corporate capitals at the ultimate expense of minority shareholders have thus prompted the scrutiny and re-examination of some of the existing corporate governance practices. Considerable interest has also been generated in empirical research on the effectiveness of various corporate governance mechanisms and regulatory framework. The question arises as to how should regulators and corporations react to the prevalent trend to better corporate governance practices – an art of term that can connote different implications to different people and generate debate on a multitude of issues. Much reforming efforts upon the corporate governance standards are engineered on the basis that they correspond to good corporate governance practices, but the outcome often remains vague. There are varying shapes of corporate governance around the globe, often reflecting the country’s own peculiar local conditions and business cultures cutting across the tide of corporate governance reform. It would definitely be futile to look for a global standard corporate governance model that suits Malaysian corporate landscape in order to increase our global comparability. Thence, this chapter proposes that Malaysia should be searching to define and adopt what it deems to be the best approach towards good corporate governance practices reform.

Nonetheless, it is acknowledged that there is no single failsafe corporate governance model and system or ultimate principles since there will still be some recalcitrant corporate manipulators who attempt to outmanoeuvre the regulators and break free from the grips of laws. Clarke (2004) agreed that “It is important that most obvious abuses will be outlawed, and loopholes closed, but the ingenuity of self-interest will lead to the devising of new schemes to evade accountability”. Instead of sitting idly, the Malaysian regulators must hunt vigorously for any red flags from the corporate activities and related-party transactions. These vigilant acts can only be done if there is visible improvement in the effective implementation of corporate governance rules and practices. A similar analogy can be derived from the recent issuance of unusual market activity (UMA) queries by Bursa Malaysia to acquire information and explanation from public-listed companies as to the sharp rise of its share price within a short span of time. On this note, the corporate regulators could effect a similar mechanism via drastic reform of the Malaysian corporate governance rules and practices in order to protect minority shareholders at an early stage.

Basically, Vaughn and Ryan (2006) argued that it is hard to strike a fine balance between sensible regulations and unreasonable enforcement whereas the most effective internal check on corporate governance is the corporate directors. However, this dissertation views that the regulators should define a clear demarcation line between the need to regulate corporations and the means to implement effective enforcement at the same time. To fix corporate governance for minority interest, putting the trust on directors entirely may not be the best solution here. This is simply because the corporate directors are largely the majority shareholders themselves who would opt for protection of their own interests in the event of conflicting interests with minority shareholders.

Blair (1995) propounded that the rethinking of corporate governance should focus on the narrow application of corporate governance on the structure and functions of the board as well as the prerogatives and rights of shareholders in participating in the decision making process. However, several elements should be present in a corporate governance system in order for this to be effective. One of the significant components of corporate governance system in Malaysia is the checks and balances between regulators and corporations. Shouldn't it be advisable for corporate Malaysia to have that effective checks and balances within the corporate structure itself? The answer is in the affirmative.

In this regard, Detomasi (2002) believed that corporate governance requires a strong public policy to be set up in a specific manner. In other words, governing laws and regulations should be explicitly spelled out in the corporate framework relating to good corporate governance practices. This signifies that it is vital for regulators to create a solid corporate governance regime to be practised by the corporate players internally as well as externally. The existence of such corporate regime must be supported by revolutionary corporate governance rules and practices due to the evolving nature of modern corporations. Hence, the regulators, in the process of monitoring the corporate activities, should not lose out from those competitive corporations who race to the top via unethical and sophisticated acts.

It has also become very apparent that the corporate scandals such as the Enron and Transmile unravelled that good corporate governance on its own cannot guarantee the triumph of a corporation for the benefits of minority shareholders. Alternatively, the growing importance of enterprise governance as the cornerstone of corporate



governance may shine some light on the protection of minority shareholders and preservation of shareholders' values. The notion of effective corporate governance recapitulates the need to promote sound business operations and balanced corporate management while taking into consideration the significance of improving the interrelations between corporations and minority shareholders as well as establishing long-standing business transactions in ensuring that the interests of all stakeholders are well-protected. It is believed that corporate governance without enterprise governance is like an almond without kernel.

One of the essential elements of enterprise governance is that corporations have to balance conformance with performance. Rather than sticking to the mere box-ticking approach, it is stoutly urged that Malaysian corporate governance reform should shift away from the box-ticking approach adopted by directors and corporate officers who blatantly ignore the effective implementation of corporate governance principles in a corporation. In other words, the regulators' attentions should be drawn to the attainment of "results-driving" conformance and not mere "box-ticking" conformance by corporations. To undertake this conformance challenges, it is envisaged that corporations should be prepared to shift their gears from compliance of mandated corporate practices to performance of constructive institutional changes.

In short, enterprise governance mainly centres on the most effectual control and management of corporate function. Aside from protecting shareholders' rights, it also emphasises on the assured accomplishment of corporate objectives leading to excellent corporate performance and sustainable profitability. The studies conducted by Khatri, Leruth and Piesse (2002) found that corporate performance can be improved if the post-crisis corporate governance reform is effectively implemented. Thus, the integrated

structure of enterprise governance with the corporate governance regime may well be directed to a competitive corporate actions and superior performance amongst the modern corporations in Malaysia.

Furthermore, the regulators must also bear in mind that the advancement of dirty tactics and tricks used by corporations in the 21<sup>st</sup> century has led to the fact that the checks and balances between regulators and corporations must not lose its grips eventually. It is pertinent to point out that the corporate ownership of shareholdings nowadays comprises largely of institutional shareholders that are basically financial institutions, multinational corporations, investment-linked funds and gigantic government-linked corporations. All of them share one common facet – they are all public-listed corporations themselves. Inevitably, stringent corporate governance laws and practices are things they would want to shun away from in managing their corporations.

Therefore, the time is right for the regulators to revisit the corporate governance regime in Malaysia by imposing a set of corporate governance best practices upon all public-listed corporations in accordance with latest corporate developments that suit the local conditions and cultures. For instance, there is a need of a group of appointed independent auditors' commission that would serve as the crucial link of corporate governance checks and balances on the selected corporations annually. This move indicates that an independent body is needed in order to ensure that the corporate actions from the bottom to the top do comply in totality with the corporate governance regime firmly established by the regulators. Besides that, it is significant for the regulators to draw up a plan for strategy and roadmap towards corporate governance reform in Malaysia. The ensuing section discusses how this plan can be possibly executed to facilitate the formulation of governance best practices.

### **3.6 Strategy and Roadmap for Corporate Governance Reform**

Generally, regulatory functions extend but not limited to the establishment and implementation of rules and regulations, effecting monitoring mechanisms and execution of enforcement activities. The World Bank (2005) has recommended in their Report on the Observance of Standards and Codes (ROSC) that the enforcement capability of the statutory regulators should be further enhanced via the strengthening of independence of regulators, rationalisation of the regulatory framework as well as the modernisation of the range of regulatory enforcement powers.

In this context, it follows that the Malaysian regulatory framework should be preventive in its prescriptive measures as opposed to prohibitive and punitive in nature. As the saying goes, “Prevention is better than cure”. The corporate governance system should embark on preventing corporations from acting to the disadvantages of minority shareholders. With the preventive-based system in mind, regulatory bodies should take corporate governance best practices as the core of the modern corporate law in implementing corporate governance rules and regulations.

Developing country like Malaysia is in need of influx of international investors to boost the economy of the nation. The quest towards better investor protection lies in the steps taken to revamp the corporate governance system which is faced with the global trend that is forming an internationally recognized corporate governance standards and principles. The breadth and depth of today’s regulatory challenge is the corollary not just of the speed, severity, and unexpectedness of recent corporate crises but also of underlying evolution in the corporate environment that has been under way for a long

time. Hence, it is pertinent for the regulators to constantly keep the corporate governance framework in Malaysia cutting edge in light of the fact that many foreign jurisdictions with the most business-friendly regulations are constantly reforming their corporate governance framework. The World Bank (2008) remarked that constant reform is important by delivering the message that “if you are not reforming, another country will overtake you”.

The recent unsatisfactory corporate governance ranking for Malaysia has warned the regulators that there is no room for complacency in the development of corporate governance framework if Malaysia wishes to be the leader in the corporate success stories. It is clearly evident that there is also no risk-proof corporate governance system where its resilience would be duly tested in times of crises. All the Malaysian regulators can do now is to always rigorously scrutinise and enhance the central theme of structural reform in corporate governance regime. In other words, the imperative corporate governance reform goes beyond mere refinement of rules and practices to the degree of regulatory perfection – strategic implementation of corporate governance best practices in the local corporations.

As the corporate governance structures and system remains an integral part of the corporate and securities law, there should also be an upward shift towards enacting a comprehensive framework on the strategy and roadmap to reform the corporate governance landscape in Malaysia. Apart from the existing Corporate Law Reform Committee formed under the Companies Commission of Malaysia, it is proposed that the regulators, relevant agencies and selected corporations can further collaborate on the issues of corporate governance and devise a complete roadmap on how to implement better corporate governance regime in the local corporate world. The roadmap may lay

down the strategies for corporate governance reform within the next 10 years whilst incorporating the appropriate actions to be taken by the relevant authorities and agencies. It is recommended that a special taskforce or various working groups may be established for the aforesaid implementation of strategy. It should be borne in mind that this establishment of working groups or taskforces is different from the existing Corporate Law Reform Committee in which the latter only consists of selected corporate experts and legal professionals from various spectrums of expertise.

Further, the special taskforce or working groups should take cautious note that corporate governance and minority shareholders' rights do not co-exist in a vacuum. Minority shareholders' rights are affected by other factors that reflect the distinctive corporate governance landscape and corporate culture. The extent to which the rights are exercised is heavily determined by the corporate structures and its business policies. Hence, all of these extraneous factors should be taken into consideration when formulating the best strategies and roadmap for corporate governance in Malaysia.

In this respect, the special taskforce will also have to constantly monitor the working progress and corporate governance development in other jurisdictions to ensure that its recommended strategies and roadmap, if any, will not lag behind the well-established international corporate governance standards, without compromising the local corporate values and cultures. It has also become apparent that corporate governance will only benefit all stakeholders only if this is a result of a well-thought-out process of strategy and roadmap which are aptly tailored to a corporation's needs. The underlying corporate governance principles and practices should also be meticulously comprehended by the various corporate stakeholders as well as the regulators. Only then will "best corporate governance practices" cease to remain as another dead phrase in order to be deeply

embedded into a corporate culture, rather than a resentful compliance with the strict letters of laws.

Be that as it may, it would still be a daunting task to reform the existing corporate governance regime as it involves the balancing of different interests which, at times, may be in conflict with each other. Successful stock guru, Warren Buffett once mentioned that managers get shareholders they deserve<sup>17</sup>. However, the contrary is equally important since shareholders expect to have managers they deserve to run a corporation, and corporations they deserve as well. Hence, the strategy and roadmap for corporate governance reform in Malaysia should be primarily driven by the force of minority shareholders' interest.

### **3.7 Conclusion**

As can be seen from the study above, it appears that the existing status of corporate governance reforms made by the Malaysian regulators and agencies to tackle the corporate scandals has been generally effective, though there is still very much room for improvement. One must not lose sight of the fact that the corporate regime is dynamic and similarly, the regulatory rudiments presented in the discussions above have merely addressed a small part of the general improvements needed for corporate governance reform. In every sense, the Malaysian regulators should always be vigilant in this context such that corporations, especially minority shareholders of corporations, may be protected and eventually advance in the long run.

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<sup>17</sup> Thomas, L. J. (January 26, 2005). Investment banker and client: A bond deepens. *New York Times*, at C1.

In a nutshell, it is the objective of this dissertation to enhance the systems for implementation of corporate governance best practices in order to facilitate the regulatory oversight functions of the relevant authorities. Laws and regulation can only form part of the entire corporate governance framework in Malaysia as other institutions such as Bursa Malaysia, Securities Commission Malaysia, Companies Commission Malaysia as well as MSWG and MICG are also part and parcel of the bigger picture in corporate governance reform. Hence, the collaboration of regulators, agencies, organisations and corporate entities may well be the answer to these vigorous changes in relation to corporate governance. Those changes are promoting wider, faster scrutiny of corporations and rendering conventional tactics less effective in addressing corporate challenges ahead.

In this regard, the uphill challenge for regulators is to put in place a set of corporate governance best practices and systems that would help to reduce the statistical probability of corporate activities turning sour from a practical corporate governance standpoint. The lesson learnt from past corporate scandals around the world lies in the ability of regulators to detect the early signs of corporate malpractices amongst Malaysian corporations to avoid the long tiring process of dragging the responsible corporate criminals to court for hearings. As such, it is most instructive to examine the corporate governance reform in the other jurisdictions for improvement to be made to the local corporate governance framework.

Undeniably, it remains a gargantuan task to effectively implement fundamental corporate governance reform since the recent tide of corporate scandals that intruded the West has pressed for a fresh focus on corporate governance in Asia, in particular, Malaysia. Nonetheless, the effort of changing the corporate landscape in Malaysia

should not be further delayed or avoided if the concerns of minority shareholders are to be assuaged. Corporate governance issues need to be addressed with some urgency in order to enhance the credibility of this territory as an investment hub in view of the current liberalisation measures taken under the recent national economic agenda.



**CHAPTER 4**

**THE NEW PARADIGM OF CORPORATE PRIMACY:  
THE CONVERGENCE OF “DIRECTOR PRIMACY” AND “SHAREHOLDER  
PRIMACY”**

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**4.1. Introduction**

The preceding chapters have identified some pertinent yet thorny issues on corporate governance. Some of these issues require further discussion on the weight that should be given to the various interests of shareholders, directors, employees, creditors, business partners, suppliers and other stakeholders of a corporation. At the threshold of managing a corporation, it is important to address the appropriate means on how to accurately articulate, properly balance and cautiously reconcile such distinctive interests in order to achieve the ends of formulating the best practices of corporate governance.

This chapter seeks to set the right tone for the remainder of this dissertation by determining whether the best practices of corporate governance should rest on a narrower premise such as the interest and power of board and shareholders’ value or rather on a wider picture of a corporation. The ensuing discussion also entails the very cornerstone of corporate governance which defines the balance between various stakeholders in a corporation. This chapter will critically examine the need for a new paradigm of corporate primacy which finds its basis from both the norms of “director primacy” and “shareholder primacy”, and then analyse various case studies to understand how a corporation may interact with its board and shareholders in the long run.

Drawing on the widely accepted definition of corporate governance, this chapter will address the central question – whether directors should manage corporations for the benefit of shareholders per se or in the best interest of a corporation. The answer lies in the concept of corporate governance that best describes the system and structure of a corporation in Malaysia. The question of “primacy” norms will also be examined from the legal perspective of how a corporation is directed and controlled by directors as well as to whom the legal duties and obligations a director owes.

#### **4.2. The Unsettled Debate between “Director Primacy” v. “Shareholder Primacy”**

The question remains whether it is the fiduciary duty of directors to tailor their decisions in line with maximisation of shareholder wealth or towards the advancement of best interest of a corporation. In terms of corporate governance, the answer lies in the different concepts of “primacy” that should be adopted by directors and management of a corporation as the basis in their decision-making process. Such discussion of concepts is very relevant as regulators, in devising a set of corporate governance best practices, would often look at the ultimate interest that board serves in a corporation.

Hence, the overarching focal point of this chapter is on the rethinking of these concepts in order to reshape the path leading to the best practices of corporate governance that will be discussed at length in Chapter 5 of this dissertation. In this regard, it will nonetheless be pertinent to first identify the existing concepts of “primacy” in various literatures. It is also necessary to appraise in how far these concepts of “primacy” entail

a complete or partial shift into a new proposed concept of “corporate primacy” in the corporate governance regime.

#### **4.2.1. “Shareholder Primacy” as the Prevalent Concept in Corporate Governance?**

The common understanding of corporate governance has long been absolute dependence on board acting on behalf of shareholders’ interests to oversee the business activities and direct the management of a corporation. Directors are mostly perceived as the guardian of shareholders’ interests since they are entrusted with the duty to conduct a corporation’s business affairs in the best interest of shareholders. As agents for shareholders, directors are entrusted with the essential duty to manage a corporation in the interests of shareholders who are principals under the purview of “shareholder primacy” norm. It was argued that “the triumph of the shareholder oriented model of the corporation over its principal competitors is now assured was attributed to the failure of alternative models” of a corporation whilst its success represents “the end of history for corporate law” (Hansmann & Kraakman, 2001).

There is abundance of literatures that support the prevalence of “shareholder primacy” norm – the “standard shareholder-oriented model” which Hansmann and Kraakman (2001) claimed to be the dominant model of corporate structure in the United States and the United Kingdom. Among other scholars, Branson (2001) further added that although the possibility of global corporate governance system converging towards such “shareholder primacy” norm remains bleak, the model in the United States seems to adhere closely to the perception that profit maximisation should be the ultimate goal of

corporations and the nation. Roe (2001) even contended that the primary objective of the business in the United States is that of shareholder wealth maximisation.

Interestingly, most of these scholars seem to question the possible global convergence of corporate governance models around the world towards the Anglo-American model which are largely structured based on the “shareholder primacy” model. In determining such a question, it leads to the issue of whether it is desirable to adopt a model which merely focuses on the maximisation of shareholder wealth. Hence, it is relevant here to discuss and analyse the concept that is heavily rested on maximising shareholder interest – “shareholder primacy”.

#### **4.2.1.1. Discussions and Analyses – “Shareholder Primacy”**

Undeniably, the evolving spirit of “shareholder primacy” has slowly formed part and parcel of many academic discussion on corporate governance. The prominence of this concept is clearly reflected in this part in which many scholars and academicians discussed why corporations should be managed in the interest of shareholders.

Generally speaking, “shareholder primacy” finds its foundation in the concept that corporate ownership belongs to shareholders on whose behalf corporate governance should be administered. Such a concept has then given rise to the principles that a corporation should be managed in the best interest of shareholders as they are the actual owners of the corporation. As contrary to the best interest of corporation, the business affairs of corporations should be directed towards the maximisation of shareholder’s wealth. As such, the concept of “shareholder primacy” tends to equate the best interests of corporation with that of shareholders (Austin, Ford & Ramsay, 2005).

At the outset, it is perceived that the interests of shareholders are deemed more important by directors as compared to the interests of other stakeholders in a corporation. The concept of “shareholder primacy” stands on the footing that the wealth of shareholders should be vigorously maximised through various corporate actions. This perception seems to suggest that maximisation of shareholder wealth constitutes the overriding aim and goal of a corporation (Mitchell, 2005). The Illustration 4.1 below shows the rudiments of the “shareholder primacy” norm.

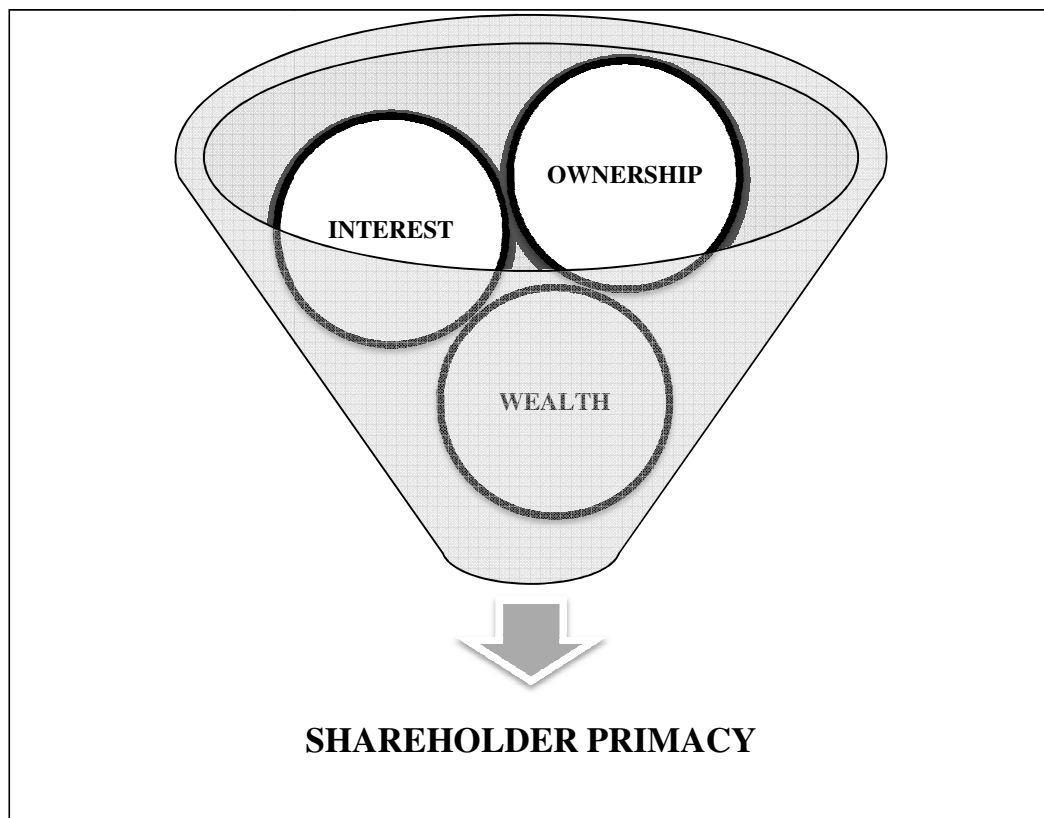


Illustration 4.1: The essential rudiments of the “shareholder primacy” concept

However, there is only partial truth in reality with regard to the ultimate aim and goal of the concept of “shareholder primacy” as it is only the majority shareholders who will have the ultimate controlling power over a corporation in real life scenarios. It is

highly unlikely that minority shareholders would even have the power to make decisions or proactively participate in the decision making process for a corporation. Although the concept of “shareholder primacy” is laudable, it remains an idealistic concept that may not withstand challenging tests that a corporation faces in this unpredictable corporate reality. Without the implementation of a proper corporate governance system, shareholders, especially minority has no or little control over the actions undertaken by directors. This brings the question to the fore – how can directors be held accountable for their acts and decisions in relation to the interest of shareholders whilst they are not subject to sufficient control by shareholders? As can be seen from Chapter 3 of this dissertation, minority shareholders are weakly protected against the stronger power of controlling shareholders in making biased decision or causing board decisions to be made in their favour.

Furthermore, directors usually have direct access to a variety of information regarding the business and affairs of a corporation. Such information often includes financial figures, confidential information and price sensitive information which are not or have not been made available to shareholders or the public. For instance, directors may attempt to exploit any price sensitive information acquired in order to manipulate the shares of a corporation with the aim of reaping excessive personal gains from such illegal activities. This corporate malfeasance refers to the notorious act of insider trading which will mostly cause minority shareholders to suffer great losses when the share prices of a corporation plunges to the bottom as a result of such manipulation by the directors.

As a result, it seems that the pure application of the concept of “shareholder primacy” may not be favourable in term of the protection of minority shareholders. After all, it

may eventually lead to abuse of power by boards to maximise the benefit of controlling shareholders at the pretence of “shareholder primacy”. However, such concept is partly applicable in the Malaysian context due to the local corporate environment and shareholders’ rights prescribed under the law.

#### **4.2.1.2. “Shareholder Primacy” in the Malaysian Context**

A closer look at the Malaysian public listed corporations would show that corporate governance regime in Malaysia is primarily driven by shareholder interests. The corporate arena in Malaysia seems to partially adopt the “shareholder primacy” concept in view of the local corporate law framework except that shareholders are deemed to be the legal owner of a corporation. The Malaysian case of *Law Kam Loy & Anor v. Boltex Sdn Bhd & Ors* [2005]<sup>18</sup> reaffirmed the English case of *Macaura v. Northern Assurance Co Ltd & Ors* [1925]<sup>19</sup> where it was said that “no shareholder has any right to any item of property owned by the company, for he has no legal or equitable interest therein. He is entitled to a share in the profits while the Company continues to carry on business and a share in the distribution of the surplus assets when the company is wound up”. Although shareholders are not deemed to be the legal owners of a corporation, the general approach by board is to treat shareholders as the ultimate owner of a corporation as they will have the legal and equitable right over the assets of a corporation in the event of liquidation or winding up proceeding.

Moreover, the corporate law framework in Malaysia also sustains the existence of the “shareholder primacy” norm due to the various shareholders’ rights and powers granted. With the legal mandate given by the Malaysian company law, shareholders have the

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<sup>18</sup> [2005] 3 CLJ 355.

<sup>19</sup> [1925] AC 619.

legal rights to vote and elect directors who constitute the board. Such legal right to vote may give rise to a direct contractual relationship between corporations and shareholders. This is simply due to the contractual election of directors by shareholders on behalf of a corporation. Hence, the appointment of directors through this contractual relationship with shareholders may also indirectly bind the board to exercise duty of care and diligence which are owed to shareholders.

Based on the concept of “shareholder primacy”, it implies that directors have the duties to manage the business affairs of corporations and to monitor its management so as to be satisfied that a corporation is being properly run in the best interests of shareholders. Apart from such “shareholder primacy” concept in Malaysia, there is also another concept termed as “director primacy” which has slowly gained its prominence in the local scene, especially in take-over cases.

#### **4.2.2. “Director Primacy” as an Alternate Concept in Corporate Governance?**

Apart from the “shareholder primacy” concept, it is interesting to note that there is an alternate concept in the corporate governance regime which is called as the “director primacy” norm. It is necessary to analyse and discuss this concept before we move on to determine the new concept to be adopted as the governance model in Malaysia.

##### **4.2.2.1. Discussions and Analyses – “Director Primacy”**

Basically, the concept of “director primacy” was advocated by Bainbridge (2001) who totally disagreed with the concept of “shareholder primacy” which is almost akin to the



“shareholder-oriented model” adopted predominantly in United States. The “director primacy” norm is distinguishable from the “shareholder primacy” norm in which the essential elements defining these two norms are that of the separation of ownership and control as well as the decision-making authority. Bainbridge (2001) claimed that it was inaccurate to say that shareholders are able to exercise corporate control via “ultimate decision making authority through proxy contests, institutional investor activism, shareholder litigation, and the market for corporate control” as far as the element of control is concerned. He argued that since the corporate law in the United States is structured on the premise of separation of ownership and control, shareholders are powerless in taking any corporate action since board or its subordinate is granted the authority to make most of the corporate decisions. Illustration 4.2 below illustrates the essential rudiments of the “director primacy” norm.

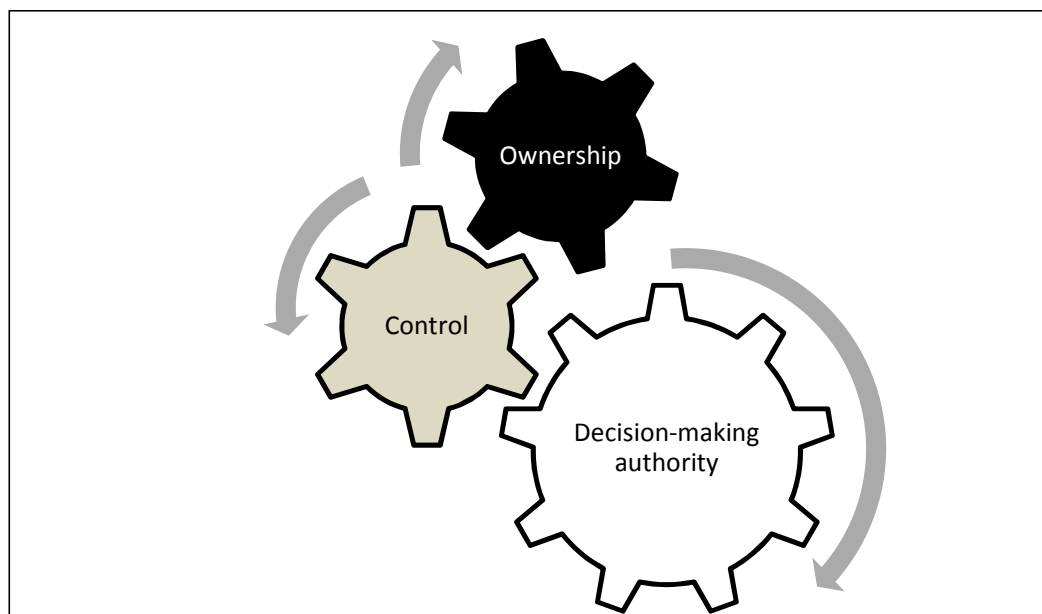


Illustration 4.2: Elements constituting the “director primacy” concept.

In this context, the “director primacy” notion opposes the very argument that shareholders play the most vital role in the decision making process simply due to the

understanding of principal-agent relationship between shareholders and directors. The “director primacy” norm rejects the argument that shareholders have ultimate ownership in a corporation since decision-making authority is vested in directors who are in a better position to maximise shareholders wealth. This is because shareholders consist of individuals with diverse interests and different levels of understanding. It would be difficult for a consensus decision to be made amongst shareholders even though they may pursue the same goal of wealth maximisation. In short, a corporation is not owned by shareholders and thus, directors are not their agents. It was argued that the board's decision-making powers do not emanate from shareholders alone, “but from the complete set of contracts constituting the firm” (Bainbridge, 2003).

To substantiate his claim, Bainbridge further argued that by analysing the distinct principles of “shareholder primacy” norm, the missing link of such norm is found in the contention that shareholders do and should have the ultimate control right over a corporation. In this context, the term “shareholder wealth maximisation” could not be used interchangeably with the “shareholder primacy” norm since the two denote distinct principles. He claimed that the objective of shareholder primacy in maximising shareholder wealth could also be achieved by vesting absolute control and decision-making authority with a board. It is merely an act of balancing the board’s authority with its accountability to shareholder wealth maximisation.

All in all, the “director primacy” norm speaks of the absolute authority vested with a board alone in making decision for a corporation. It means that shareholders should be taken out of the whole picture of decision-making process since directors are also accountable to maximise shareholder wealth via the exercise of their discretionary authority in a corporation. As such, it is an idealistic concept where directors are

entrusted with the sole decision-making power without any shareholder participation at all. Both the concepts of “shareholder primacy” and “director primacy” share the common goal of shareholder wealth maximisation. The Illustration 4.3 shows the similarity and difference between the two concepts.

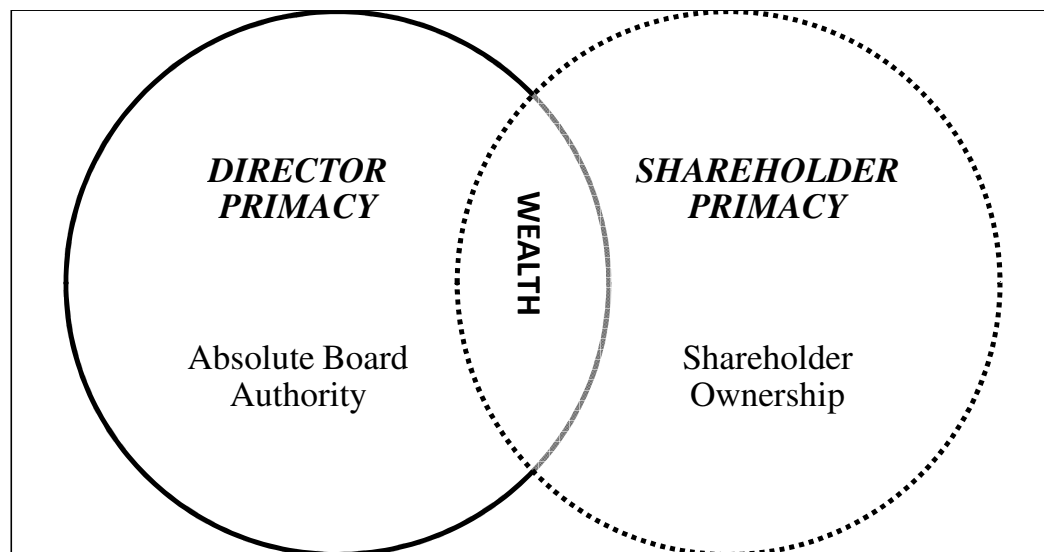


Illustration 4.3: The similarity and difference between the concepts of “shareholder primacy” and “director primacy”

Nonetheless, the pure application of such a “director primacy” concept will lead to expropriation of minority interest as the board authority is not subjected to any vigorous scrutiny by shareholders for the purpose of check and balance. Be that as it may, such application of the “director primacy” concept can also be seen in the Malaysian context of take-over issues.

#### **4.2.2.2. “Director Primacy” in the Malaysian Context**

In relation to the application of “director primacy”, the Malaysian corporate law is best described in corporate take-over transactions. At present, a Malaysian public-listed

corporation may be privatised via the few avenues such as the offer to take over under the Malaysian Code on Take-Overs and Mergers 1998, substantial asset disposal or selective capital reduction and arrangement under Companies Act 1965, voluntary delisting from Bursa Malaysia and other corporate actions. One must bear in mind that all such corporate actions may lead to consequential devastating effect upon minority shareholders if the directors' vast powers are not properly contained and scrutinised. For instance, the means to take over via substantial asset disposal under the Companies Act 1956 is most instructive in illustrating a dramatic corporate transaction involving the application of "director primacy" norm. Although approval at a general meeting is required for such a disposal by directors of the corporate undertaking or property under Section 132C of the Companies Act 1965, passing through the approval process is not hard in view of the board's dominant control over the general meeting.

Recently, EON Capital was caught in the tussle amongst its major shareholders due to the proposed take-over of all its assets and liabilities by Hong Leong Bank Berhad. Most often than not, such tussle arises from conflicting interests between different parties – the board, management and shareholders. The take-over offer also involved the interest of a corporation as a whole. If the corporate unrest continues, the end loser will be the minority shareholders. As such, the question remains whether directors should be given the absolute right of deciding on behalf of corporations and shareholders, especially in take-over transactions.

Inadvertently, a take-over bid will indirectly give rise to overt conflicts of interest between directors and various stakeholders of a corporation, in particular the interest of shareholders. The possible arising conflict is due to the reason that board of offeree corporation has to consider whether the offer made by the offeror corporation is in the

best interest of the offeree corporation. Most often than not, it is hard for directors to weigh the interests of various stakeholders within a corporation as consensus for the best interests of a corporation is highly unlikely to be reached in such a complex situation. Not only that the offer has to be made to the board first, directors will have direct access to more significant information that may lead to insider trading by the directors. The manipulation of such information for the purpose of insider trading may further widen the gap of conflicting interests amongst the stakeholders of a corporation.

Although the offer to take-over through acquisition of the offeree corporation's shares is being directed to shareholders of the latter, it has to be conveyed or communicated to the offeree corporation's board in the first instance. Furthermore, this so-called offer for the "acquisition of assets and liabilities" of the offeree corporation needs to be firstly approved and accepted by its board prior to the board's recommendation to shareholders for their acceptance of the take-over offer. In any event, the problem of potential diverging interests is aggravated when directors reject the take-over offer for the ulterior purpose of retaining control over a corporation or accept the take-over offer to reap personal benefits. In the event of rejection of offer, this demand of control may arise from the fear of directors that a particular corporate take-over will result in the change of shareholdings which may eventually lead to the change of boardroom as well. In frustrating the take-over offer, directors may also seek protection under the wide-ranging umbrella of "best interests of the corporation" and the defence of business judgment rule. Hence, directors will always have the first bite of the "take-over cherry" where they may prevent the opportunity of having the second bite of the cherry from reaching the general meeting for shareholders' approval.

In fact, the worst case scenario may also occur in the event that the offeree corporation's board accepts the offer and recommends it to shareholders. To avoid the offer from being rejected by shareholders, the board may choose to withhold certain vital information from coming within the knowledge of their shareholders in collaboration with the offeror corporation. For whatever reason it may be, the undesirable conduct of withholding the take-over information will inevitably have an impact on the process of deliberation by shareholders in reaching an informed decision to accept or reject the offer. As a result, the board may achieve their ultimate goal of benefiting themselves at the pretext of benefiting a corporation as a whole.

From the foregoing discussion, it is obvious that the "director primacy" concept may not be the most suitable governance concept or model for Malaysia in view of the rampant cases of disputable take-over transactions. As a result, there is a need to revisit the appropriate "primacy" notion that a corporation should follow in formulating a set of corporate governance best practices.

#### **4.3. Emergence of the Concept of Corporate Primacy: The Means and Ends of Corporate Governance**

It is now clear that minority shareholders are not totally safe from the expropriation of controlling shareholders and the board's abuse of power as highlighted in the above concepts of "shareholder primacy" and "director primacy". Hence, this dissertation seeks to advocate a new notion of "corporate primacy" which can be termed as "*Corprimacy*". Accordingly, this new concept of *Corprimacy* would suggest that there is a pressing need for fresh reform of the corporate governance regime in Malaysia in order to accommodate the ever-changing corporate landscape.

This section explains the concept of *Corprimacy* and examines its application in the formulation of the corporate governance best practices to protect minority shareholders. As contrasted with the concepts of “shareholder primacy” and “director primacy”, this new concept embarks on a different understanding on whose interest should a board consider as the primary factor in their decision-making process. There are also discussions on two recent case studies to delve into how the *Corprimacy* norm may be effective in protecting minority shareholders. The discussion of this new concept will definitely be used as the means to achieve the ends of this dissertation – the protection of minority shareholders via the formulation of corporate governance best practices of which will be further discussed in chapter 5 and 6.

#### **4.3.1. *Corprimacy* Explained – Convergence of “Shareholder Primacy” and “Director Primacy”**

As explained above, it is noted that the common goal of the concepts of “shareholder primacy” and “director primacy” is that of shareholder wealth maximisation. In other words, the convergence point of both concepts is at the shareholder interest rather than at the best interest of a corporation. One shall understand that the total maximisation of shareholder interest does not necessarily end up in the best interest of a corporation which is considered as the key element in protecting minority shareholders. There is a specific section 4.3.2 on how the *Corprimacy* approaches the “best interest of the corporation” as mandated under the Malaysian company law. First of all, this section looks at how the convergence of “shareholder primacy” and “director primacy” concepts can explain the essential rudiments of *Corprimacy*.

Borrowing the words of Bainbridge (2003) in relation to the “director primacy” concept, a director supposedly serves as a “Platonic guardian” who watches over the interest of a corporation. Bainbridge descriptively argued that “corporate law vests the board of directors with a non-reviewable power of discretionary fiat”. In practice, directors do not put the interest of corporations in the forefront. This is due to the existing tension of conflicting interests and over-reliance on its management. It is a fact that a board will hardly possess all the necessary skills or information to govern and manage a corporation. They still need to rely on the information or expert advice provided by other officers in the corporation or professionals hired. Due to such heavy reliance on the management, it would be a daunting task for directors to vigorously guard the interest of the corporation. As such, there shall be a check and balance mechanism that ensures the equilibrium of board accountability and decision-making authority. Under the corporate law of the United States, Bainbridge (2002) opined that “control is vested in the board - not shareholders” as the board of directors is an institution of corporate governance. Bainbridge (2002a) also justified his argument that control is ultimately vested in the board under the corporate law of United States instead of the Chief Executive Officer since “groups make better decisions than individuals under certain conditions” and “group decision-making is an important constraint on agency costs”.

These issues raise the concern regarding the viability of “director primacy” or “shareholder primacy” norm. As for the concept of “director primacy”, the central basis lies in the weak controlling powers of shareholders where control is vested in a board. Strictly speaking, it does not make any significant difference to argue that “director primacy” connotes more controlling power which is vested with a board since it still does not rule out the fact that a director must exercise his control in the best interest of a



corporation. In the world of *Corprimacy*, there is no one single stakeholder who plays more superior role than the others. As a separate legal entity, a corporation must not be sustained in the long term without the overall complementary roles played by all relevant stakeholders like directors, shareholders, employees, creditors, suppliers and so forth. These complementary roles act together as the supplementary forces that support the pillars of governance system of a corporation. In other words, it is not necessarily important to address the superiority of directors in controlling a corporation since sound corporate governance structure requires the concerted effort from various corporate constituencies.

Although the “director primacy” concept claims that directors have the ultimate control over a corporation, it is not an unusual phenomenon cutting across every single corporation, in particular in Malaysia where some of the major public-listed corporations or government-linked corporations have institutional shareholders who hold substantial stakes in the shares of some corporations. For instance, as an enormous pension fund, the Employee Provident Fund holds various large shareholdings in many highly valued public-listed corporations like Sime Darby Bhd, Malayan Banking Bhd, Tenaga Nasional Bhd, Malaysian Resources Corp Bhd (MRCB), IOI Corporation Bhd and so on. Usually, these substantial stakes will entitle them some seats on the board representation of which it signifies indirect board control. Even if there is no board representation, such major institutional shareholders have sizeable control on the direction of a corporation via their shareholding power and pressure on the board. They may be the ones who have the ultimate majority control over a corporation and not the board. Thus, it is not correct to say that all the controlling power is entrusted on a board alone without due consideration of controlling power of the institutional shareholders or individual substantial shareholders who are not part of the board. As the saying goes,

“absolute power corrupts absolutely”. This is the main objective of *Corprimacy* where there shall be a balance of control between the board and shareholders. Such shareholder control can be cultivated via their dominant roles of participation and activism.

Basically, it is not the intention of *Corprimacy* to take away the decision-making authority of directors in a corporation. Rather, it is propounded that shareholders should be given more dominant role in steering the direction of corporations as well as more power to influence the board’s decision as when the need arises. Dent (2008) supported that shareholder influence should be enlarged through the mutual agreement with the corporation. Stout (2007) rightly pointed out that “if investors truly believed greater shareholder control meant better corporate performance, they could ‘vote with their wallets’ by preferring shares in firms that give shareholders more control”. It means that the shareholder control may be transformed into greater shareholder pressure on a board via the threat of pulling out their share investments from the corporation.

From the opposite side of the same spectrum, “shareholder primacy” advocates that directors shall run a corporation in the interest of shareholders in view of the fact that they are the agents of their principals – shareholders who are predominantly the owners of the corporation. In response to this, Blair and Stout (1999) predicted that “the way corporate law actually works in practice is consistent with the notion that directors are independent hierarchs whose fiduciary obligations run to the corporate entity itself and only instrumentally to any of its participants” and they are not agents because “they are not subject to direct control or supervision by anyone, including the firm’s shareholders”. Legally speaking, it is indeed true that directors are not agents of shareholders but rather they owe fiduciaries duties to a corporation itself. One should

not lose sight of the fact that these fiduciary duties originate from the legal responsibilities that a director owes to a corporate entity.

The very existence of a public-listed corporation survives on various constituents that form and support the corporation. This is very different from the context of a privately held corporation where there are only a few directors who own all the shares in the corporation. The constituents in a public-listed corporation include the stakeholders like shareholders, employees, creditors, suppliers and so forth. Pure objective of shareholder wealth maximisation will not secure the best interest of a corporation. This is because a corporation survives on the lifeblood of capital from its shareholders and creditors, business interest with the suppliers and customers as well as working hands of the employees. Furthermore, the sole objective of shareholder wealth maximisation may not sustain the long term interest of a corporation if directors are also the majority or substantial shareholders of the corporation. In such a scenario, it is hard to ignore the personal interest of the board have in a corporation itself. It should be borne in mind that the strong presence of controlling shareholders on board representation does not necessarily mean that the board should only strive for the shareholder wealth maximisation to the extent of neglecting the interests of the other stakeholders like minority shareholders, employees, creditors, suppliers and so forth. If these interests are not given due consideration that they rightly deserve, it will ultimately create a domino adverse effect upon minority shareholders. For instance, if the employees' interests are not properly considered by a board, there may be mass resignation of employees who protest against the board policy. This will create instability in a corporation where minority shareholders' interest could be affected by the sharp decline of shareholder value.

All in all, the concepts of “shareholder primacy” and “director primacy” could be realigned to constitute the ultimate objective of *Corprimacy* – the protection of minority shareholder. *Corprimacy* comprises of the goal of higher shareholder control and balanced shareholder wealth maximisation with the convergence point of both the concepts of “shareholder primacy” and “director primacy” at the best interest of corporations which is further discussed in the next section. The Illustration 4.4 below illustrates the fact that the “shareholder primacy” may be harmonised with the “director primacy” concept in order to arrive at the new concept of *Corprimacy*.

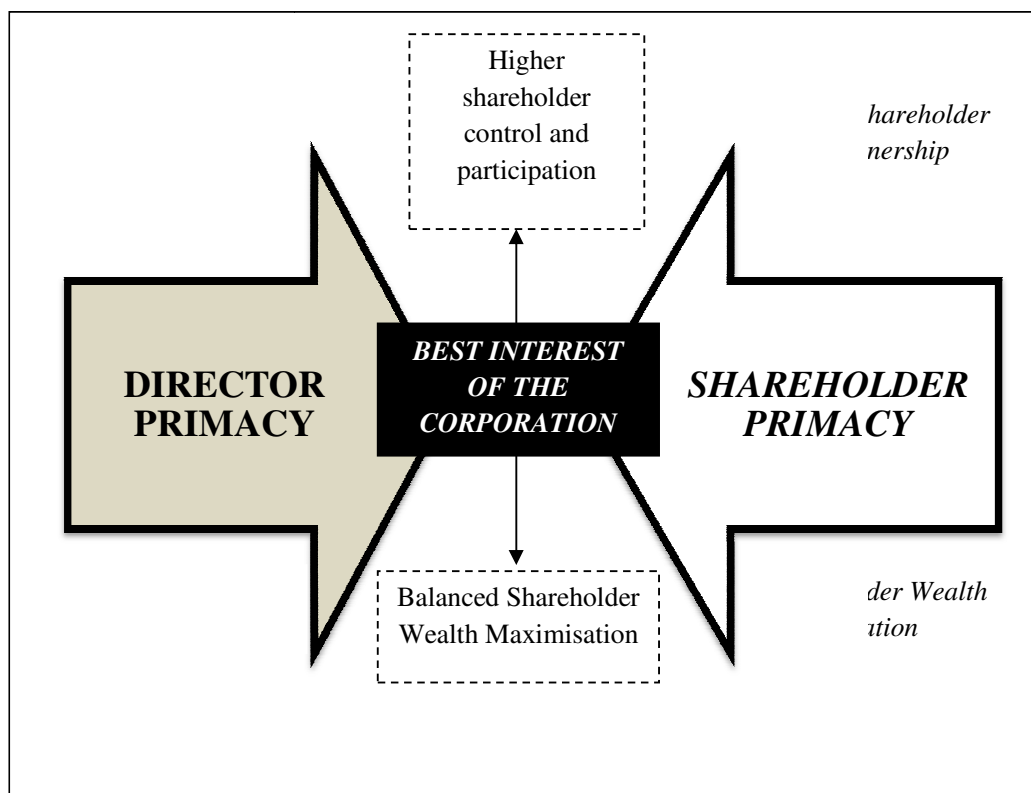


Illustration 4.4: The convergence of director primacy and shareholder primacy towards *Corprimacy*

#### 4.3.2. The *Corprimacy* Approach towards “Best Interest of the Corporation”

The foregoing discussion points to the *Corprimacy* approach towards “the best interest of the corporation” in laying the foundation for the corporate governance best practices (as illustrated in Illustration 4.5 below). Such understanding of *Corprimacy* is vital for a board to adopt a set of corporate governance best practices that will lead to higher shareholder control and participation as well as a balanced shareholder wealth maximisation that benefits a corporation as a whole. This set of corporate governance best practices is formulated in chapter 5 and the concluding chapter 6 with the ultimate aim of protecting minority shareholders.



Illustration 4.5: The *Corprimacy* approach towards the best interest of the corporation

Basically, section 132(1B) of the Companies Act 1965 requires directors to exercise their business judgment in the best interest of a corporation in order to avoid breach of their fiduciary duties to the corporation. The “best interest of a company” is not statutorily defined in the statute. On this note, the High Level Finance Committee has recommended in its Report on Corporate Governance that it should not be statutorily codified after considering the need to maintain the flexibility of such term. However,

this dissertation recognises that there is a need to statutorily clarify the term “best interest of a company” as clear definition of such term would lead to certainty of law on the duties of directors. Prior to the coming into force of Companies Law (Amendment) Act 2007, the old provision required a director to act honestly and use reasonable diligence in the discharge of his duties under Section 132(1) of the Companies Act 1965. Notwithstanding that the current provision still requires a director to act in good faith in the best interest of a company, it does not clearly spell out in whose interest the business and affairs of a corporation should be managed or directed. This is due to the absence of definition on the “best interest of the company” in the law. In this regard, directors have no clue whilst deciding whether to consider the interests of other stakeholders like the creditors, employees, customers and so on.

At this juncture, suffice to say that it is important to stipulate its definition for the purpose of defining the duties that directors owe to a corporation. Inevitably, the clarification of “best interest of a company” will then further substantiate the argument that *Corprimacy* should prevail over the “director primacy” and “shareholder primacy”. Moreover, the cautious formulation of *Corprimacy* as the central theme for directors’ duties rebukes the misperception amongst directors who believe that they are appointed to represent the best interests of shareholders who are responsible for their appointment. Notwithstanding the significance to have statutory clarification on the term “best interest of a company”, one must not lose sight of the complications that may arise from clarifying this term in view of the fact that the term addresses varying definitions in different contexts. Hence, it may be said that the term entails different applications which necessitate separate analysis of directors’ duties on a piecemeal basis.

For instance, there may be situations where directors are required to consider the interests of shareholders as a whole. Usually, these situations involve corporate transactions or decisions that would substantially affect the rights and interests of shareholders. This is because shareholders' interests, as a group, would be put at stake in corporate transactions like alteration of corporation's constitution, merger and acquisitions, corporate take-over, large share transfer or acquisition, exploration of new businesses and disposition of substantial assets belonging to the corporation. On the other hand, the interests of creditors may be placed in priority over other stakeholders in the event that a corporation is near to insolvency or in cases where a winding up proceeding has been instituted against the corporation. For the purpose of flexibility, it is understood that the Malaysian law does not provide a conclusive definition of the term "best interest of the company" as its application is not exhaustive in nature. As such, it is the objective of *Corprimacy* to ensure that a board adheres to governance best practices in determining the best interest of a corporation.

Striking the same chord with *Corprimacy*, board is legally required to exercise its powers in the best interest of a corporation. In terms of corporate governance, this dissertation argues that it does not paint an accurate picture to say that directors owe direct legal duties to act in the best interest of shareholders only. Both the concepts of "director primacy" and the "shareholder primacy" assume that the board should seek to uphold the best interest of shareholders – the shareholder wealth maximisation. Be that as it may, *Corprimacy* entails a completely different view on the model of corporate governance that should be moulded in accordance with the proper understanding of the "best interest of the corporation". Although a board owes a primary responsibility to shareholders, the interests of other stakeholders are hard to be ignored in view of the best interest of a corporation.

As compared with the understanding of “best interest” in United Kingdom, Section 172 of the UK Companies Act 2006 states that a director has a duty to promote the success of a corporation for the benefit of its members as a whole, having regard to:

(a) the likely consequences of any decision in the long term, (b) the interests of the company’s employees, (c) the need to foster the company’s business relationships with suppliers, customers and others, (d) the impact of the company’s operations on the community and the environment, (e) the desirability of the company maintaining a reputation for high standards of business conduct, and (f) the need to act fairly as between members of the company.

From the reading of the aforesaid provision, it can be seen that the company law in the United Kingdom has crept away from the restricted interpretation of “best interest of a corporation” towards a more encompassing approach that takes into consideration the likely long term consequences of any decision, the importance of good corporate reputation, the principles of fairness within a corporation as well as the interests of the various stakeholders. Hence, the Malaysian governance practices should be tailored with such duty to promote the success of a corporation for the best interest of all stakeholders which would result in better protection for minority shareholders.

A case in point to illustrate *Corprimacy* is that of the Transmile scandal. The corporation’s over-leveraging of borrowings to purchase new fleets of airplanes had unnecessarily incurred exorbitant liabilities on the corporation itself. Due to such huge debts, some of the directors who are prosecuted by the Securities Commission sought to



avoid the share price from plunging to the bottom via the submission of false financial reports to the Securities Commission. Such inconsideration of the best interest of the corporation generally has caused a fortune not only to the corporation but also a great loss of shareholder value. Transmile may not be sustainable due to the liabilities owed to the creditors. This is because the creditors may institute winding-up proceeding upon the corporation which in turn would threaten its sustainability. If the corporation is unable to service its debts or make a quick turnaround, it may risk the fate of being wound up or collapse. This neglect of best interest of the corporation has put shareholders, especially minority ones at stake. The inability of repayment of debts may also end up in massive retrenchment of employees which will affect the daily operation of the corporation's business activities. If the board had taken the best interest of all the stakeholders into consideration, they could have decided otherwise in regard of the purchase of airplanes. They may also think twice before committing the fraudulent misconduct of submitting false statement to the Securities Commission.

The importance of considering the best interest of a corporation can also be seen in Section 132(1E) of the Companies Act 1965 where the nominee director is bound to act in the best interest of a corporation in the event of conflict with the interest of his nominator. In other words, nominee shall only act in the interest of his nominator who is normally the shareholder of a corporation. He owes a duty to the corporation that he is serving rather than the nominator who appointed him. Hence, the prevalence of the best interest of a corporation over other individual interest reaffirms *Corprimacy* that all the stakeholders' interests are to be considered in the board's decision-making process.

In short, *Corprimacy* aims to create a win-win situation for every stakeholder in the best interest of a corporation. As part of the corporate governance best practices, a board

should also consider the possible implication of their decision or action on a corporation. Their consideration of the best interest of a corporation can be equated with their duty to promote the success and sustainability of a corporation for the protection and enhancement of shareholders' value. The Illustration 4.6 describes the understanding of stakeholders based on the *Corprimacy* approach towards the best interest of a corporation.

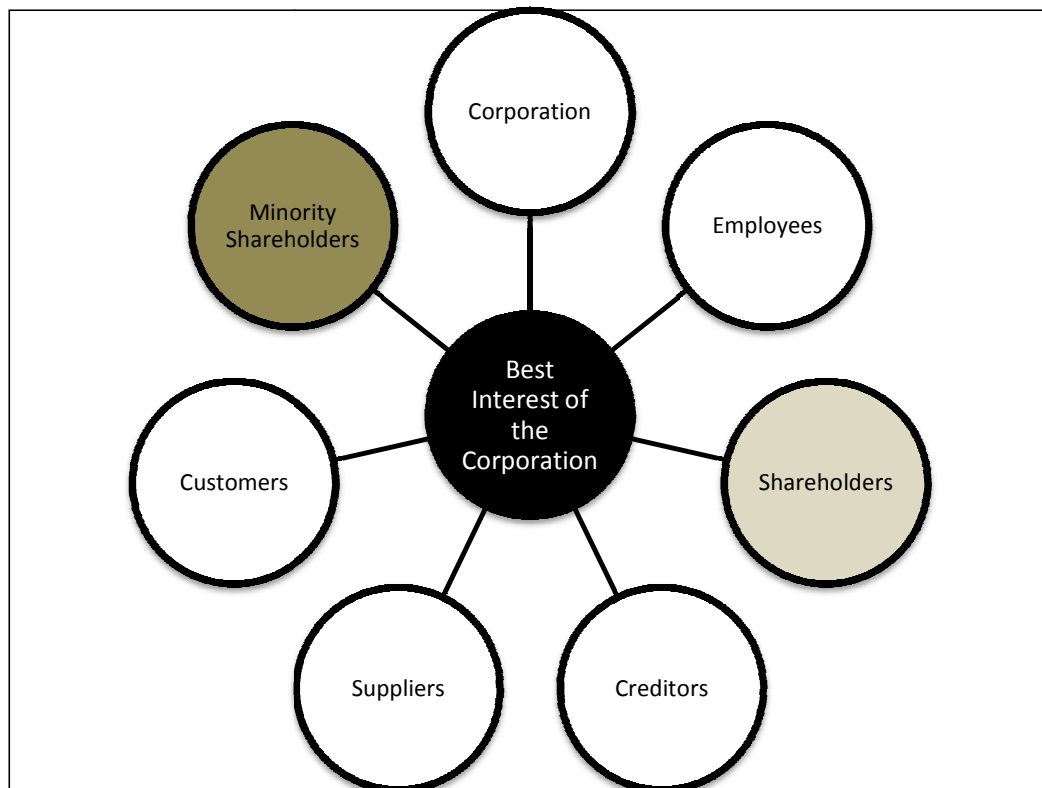


Illustration 4.6: Understanding of best interest of the corporation

#### **4.3.3. Inside the *Corprimacy*: Does It Really Matter?**

At first glance, we must be questioning the real rationale or intended purpose of propounding another concept of “primacy” whilst discussing the issues of corporate governance. This puzzling question actually goes back to the basic question of whether

corporate governance really matters to the realm of corporate law. Perhaps, one may argue that *Corprimacy* may at best give rise to just another emblematic “primacy” argument which will never find its meeting point with other similar “primacy arguments” by scholars at the end of the road. Scholars will doubt the necessity and practicality as regard to the creation of conflicting “primacy” in the realm of corporate governance.

In fact, the differences between “shareholder primacy” and “director primacy” do not really matter. It also does not matter whether the global corporate governance models are converging towards either “primacy” norms. Rather, it is advocated that the convergence point should be directed towards the *Corprimacy* approach of best interest of a corporation. This is because the implications of certain legal rules that govern the division of powers between corporate stakeholders are often examined based on the short term and long term values of the shareholder. Thence, this dissertation attempts to clarify the many doubts arising out of the rationality of adopting this new *Corprimacy* through exploratory analysis on its functionality as well as its practical application in shaping a new model of corporate governance for the protection of minority shareholders. With such a new model, it is hoped that it will help to set the right course for directors in managing and directing the business and affairs of corporations.

Bearing these objectives in mind, *Corprimacy* essentially pushes for a fresh rethinking of the corporate governance framework that is commonly implemented throughout most of the corporations. It does not necessarily imply that the corporate players should completely pay no heed to the established principle that shareholders’ interests must be vigorously defended. After all, this is what corporate governance matters in preserving shareholders’ value as well as protecting minority shareholders’ interest – the central thesis of this dissertation. In other words, there is neither radical change from the

existing concepts of “primacy” nor drastic deviation from the well-established principles of corporate governance when it comes to *Corprimacy*. It merely differs in terms of the understanding of best interest of a corporation and the practical application of *Corprimacy* in formulating the corporate governance best practices. Henceforth, *Corprimacy* may be adopted to set the tone for the formulation of corporate governance best practices that this dissertation seeks to achieve.

Essentially, there is a pressing need to have an efficient system of corporate governance that provides sufficient supervision over the roles and duties of directors in order to avoid abuse of powers by them. Such a system must not only serve to warrant that directors and officers of a corporation comply strictly with all laws and regulations but also to ensure that they constantly act and make their decisions in the corporation’s best interest. After all, the underlying principles of *Corprimacy* capture the the essential ingredients of corporate legal rules of which both the concepts of “shareholder primacy” and “director primacy” have overlooked. A deeper understanding of corporate law will also unravel the corporate governance best practices based on the best interest of a corporation, significance of directors’ roles, separation of governance and management, proximate interplay between shareholders and corporation and so forth. All these elements will be further explained and critically examined in the following sections.

#### **4.3.4. Application of *Corprimacy* in the Formulation of the Corporate Governance Best Practices**

The application of *Corprimacy* in the formulation of corporate governance best practices in this section covers, amongst others, the separation of governance and management role, the redefining of directors’ roles as well as harmonising the rights

of the majority and minority shareholders. All of these application and understanding are important to set the right path for the formulation of corporate governance best practices in the ensuing chapters.

#### **4.3.4.1. Separation of the Dual Roles of Governance and Management**

First of all, there shall be a clear understanding on the difference between the terms “governance” and “management”. However, this distinction may seem to be ambiguous and both terms are often muddled in practice. It is imperative to clearly understand the distinctive definitions and usage of governance and management as it delineates the interplay between the roles of board and managers.

The management tasks of a corporation are usually delegated to the appointed management team or top executives of the corporation. In *Burland v. Earle* [1902]<sup>20</sup>, Lord Davey stated that “the Court will not interfere with the internal management of companies acting within their powers, and in fact has no jurisdiction to do so”. As such, there is legitimate expectation that these executives will diligently carry out their corporate actions and effectively manage the entire corporation in accordance with their respective assigned portfolios. On the other hand, the duty of governance is legally entrusted to the board of a corporation in which they shoulder the legal obligations to oversee the work or performance of the management team as well as to ensure that conflicts of interest are resolved wherever possible. In other words, a management team is answerable to the board for every corporate action they take in the course of business. Such board-management relationship would mean that board governance has

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<sup>20</sup> [1902] AC 83, 93.

intertwined roles with the management as the decision or plan made by the former will be transformed into actions by the latter. Hence, both governance and management have relatively significant impact on each other.

In case of conflicting decisions between board and management, board authority shall prevail as provided under the corporate law. Being an institutional structure, most corporations seem to position their boards at the apex of corporate hierarchy where the boards have the power to appoint and dismiss their management. Nonetheless, it remains to be seen whether the superior position of board entails it to be described as a model of “director primacy”. Theoretically, it is sound to vest the powers of governance in the hands of board. Being responsible for the governance of the corporate structure, a board is in charge for the hiring as well as firing of the top executives or management team in a corporation. However, the rationale of retaining this conventional practice has gradually changed due to the latest development of corporate law. In the modern corporate practice, it is hard to have a total clear-cut separation of governance and management. Most often than not, the dividing line is muddled by the hesitation of board in sacking the top executives like the Chief Executive Officer or President since they feel that it is time-consuming and costly to do so.

Moreover, a Chief Executive Officer or President who is usually the founder of a corporation, will be the one that recommends directors to be elected into the board at the general meeting. As the founder or successor to the corporation, the thin dividing line between governance and management is completely erased from the horizon of organisational structure in which the same individual will hold the highest post in the management chart as well as the chairmanship of the board. Such management pressure upon the board would prejudice the board’s decision-making process in the governance

system of a corporation. This flies in the face of *Corprimacy* which advocates the best interest of a corporation. This is because the CEO's interference in the governance role of a board can lead to possible abuse of power.

Without a clear separation of the dual roles of management and governance, the shareholder approval process of either the appointment or dismissal of directors becomes an uphill battle since the management is the one who will select and nominate the board members. Similarly, it will be easier for CEO to appoint top executives as he or she has the ultimate control over the board which would approve the nomination. As a result, this may lead to the concentration of directors and executives who are connected via close family ties or other related relationships or interests amongst them. Hence, the objective of check and balance mechanism in controlling a corporation will inevitably be compromised by such a highly family-dominated corporate structure.

In relation to a sound corporate governance framework, Detomasi (2002) expressed the view that the board's function is to primarily examine the strategy of a corporation on the whole by continuously searching for "weak points in the organizational functions and operations" and "by retrospectively studying the previous decisions made by the corporation". Therefore, as the apex of the governance structure in a corporation, a board should play their oversight role in directing the management via their policies and strategies. Directors should guide the management in implementing their decisions in accordance with the corporate governance best practices. All in all, the distinctive nature of the governance and management shall not divide the supplementary roles between board and management. Rather, it should strengthen the execution of these separate roles in the best interest of a corporation.

#### **4.3.4.2. Redefining the Roles of Directors as the Cornerstone of *Corprimacy***

First and foremost, it is noted that there is no one comprehensive definition of whom and what constitutes a “director” in a corporation under the Companies Act 1965 since Section 4 of the Companies Act 1965 only defines a director as “any person occupying the position of director of a corporation by whatever name called and includes a person in accordance with whose directions or instructions the directors of a corporation are accustomed to act and an alternate or substitute director”. It is simply not adequate for one to thoroughly understand the nature and roles of a director by merely reading between the defining lines in the Companies Act 1965.

Recognising the discrepancy found in the definition of “director” under the Companies Act 1965, it is commendable to note that the Securities Commission Malaysia has recently endeavoured to extend the scope of the definition to include officers that occupy the top management of a corporation through the passing of the Capital Markets and Services (Amendment) Act 2009. For the purpose of the new provision on prohibited conduct of director or officer of a listed corporation under Section 317A, paragraph 4 of that provision reads that “‘director’ includes a person who is a director, chief executive officer, chief operating officer, chief financial controller or any other person primarily responsible for the operations or financial management of a company, by whatever name called”. As such, the coverage of who assumes the role of a “director” is widened in order to reflect the corporate reality in which those who are primarily responsible for the operations or financial management of a corporation do not come



under the definition of “director” as they are merely the management team employed by a corporation.

In this context, the insertion of the new definition of “director” under the new Section 317A of the Capital Markets and Services Act 2007 is deemed as a major step towards enhancing the accountability of top management executives in view of the fact that they are usually the ones that run the day-to-day business and affairs of a corporation. Most often than not, they are also the ultimate decision-makers whose decisions are subsequently endorsed or rubber-stamped by the board. The enhanced scope of the definition is not too-far-fetched and it must not be seen as a burdensome measure that restricts the creativity of the management. It follows that the aforesaid new definition of “director” should be incorporated into the Companies Act 1965. Even if the Parliament’s intention is to leave the definition of “director” as it is in the Companies Act 1965, *Corprimacy* entails that the roles of a director should be further enhanced in order to include the roles of the management.

Apparently, there is a need to strike a balance between excessive authority and absolute accountability pertaining to the roles of a director. In line with *Corprimacy*, the governance structure of a corporation must be crafted in such a way to include the accountability of its management arm in order to make directors and officers collectively responsible for the operation of the corporation. Since early beginning of the 20<sup>th</sup> century, the term “corporate governance” has been a contentious phenomenon in the United States, where the famous co-authors of the book “The Modern Corporation and Private Property” – Berle and Means (1932) was of the view that the majority of public corporations are operated not in the interests of their supposed owners – shareholders, but in the interests of the management of the corporation.

On the contrary, Kala Anandarajah (2001) argued that a director is legally obliged to carry out his duties with a view to enhancing the interest of a corporation either by increasing profits, reducing costs or even positive publicity of the corporation. Hence, it can be seen that there are diverging views as to whose interest should a board seek to enhance or protect. It goes back to the discussion on the legal responsibilities and duties of a board. In the course of explaining *Corprimacy*, it is important to revisit the proper understanding on the legal responsibilities and duties of the board. This section reveals that the regulators and scholars are bound by the conventional interpretation in defining and formulating the directors' duties and functions. As a result, this has inevitably led to the restricted application of directors' duties in the realm of corporate governance based on the limited models of corporate governance, namely, the "shareholder primacy" and the "director primacy".

Though the heated debate on which "primacy" should prevail continues relentlessly, it is imperative to note that regardless of which scholarly opinion wins the arguments of "primacy" in due course, the extent to which the legal duties and obligations a director owes must be clearly defined and understood before any further contention proceeds. In this regard, the first question ought to be asked is – to whom such legal duties and obligations directors owe in corporate law? The answer to this question will determine the appropriate factors that directors should consider in their decision making process. It is then prudent that directors will have a clear-cut mindset and direction as to the measurement of the balanced interest within a corporation. To respond to this question, it is necessary to peruse the relevant laws in order to reach a satisfactory finding that suits the local corporate cultures.

With regard to the roles and functions of a board, Section 131B(1) of the Companies Act 1965 states that “the business and affairs of a company must be managed by, or under the direction of, the board of directors”. It is clear that a board has the mandatory obligation to either manage or direct the business and affairs of a corporation as this section uses the word “must”. Such stipulation aims to reinforce the wordings contained in Article 73 of Table A of the Companies Act 1965 which also states that “the business of the company shall be managed by the directors”. From the legal point of view, Section 131B(1) of the Companies Act 1965 is distinguishable from Article 73 of Table A of the Companies Act 1965 as the entire running of the business and administrative operation of a corporation lies solely in the hands of a board as the former uses the words “business and affair” whilst the latter only covers business. Hence, it is wider in scope in relation to the roles and duties of a board as it enhances the management or supervisory functions of directors.

However, this legal obligation is not absolute and unqualified as it is toned down by a qualifying provision under Section 131B(2) of the Companies Act 1965 which provides that “the board of directors has all the powers necessary for managing and for directing and supervising the management of the business and affairs of the company subject to any modification, exception or limitation contained in this Act or in the memorandum or articles of association of the company”. The rationale of having such a qualifying provision goes in tandem with the purpose of limiting the roles and powers of a board. Although a board generally has unfettered powers needed to manage and oversee the whole corporation, Section 131B(2) specifically allows the company’s constitution to modify or limit their powers completely or partially. Thus, it does not necessarily mean that directors must manage or direct the business and affairs of a corporation themselves since they may effectively delegate these powers of managing to the top management of

a corporation via the memorandum or articles of association of the corporation. By reading this provision per se, one may come to the interpretation that the law has provided an alternate channel for the board to minimise their responsibilities to the least possible. This “escapism” from liabilities may happen in the event that a board calls for a general meeting to obtain consent from the members of a corporation in order to delegate most of their powers to the management by altering the corporation’s constitution. The likelihood of being successful in doing so is quite minimal within a corporate structure which has more public shareholders who are not related to the directors as it will be difficult to achieve a special majority to amend.

On the flip side of the same coin, the Malaysian corporate structure is family-dominant and shareholding-concentrated in which directors are also the substantial or majority shareholders in a corporation. Most often than not, these directors would have no trouble to make decisions for furtherance of their own interests. Mohammad Rizal Salim (2009) reiterated that “the low threshold of public shareholding spread required of listed companies and a relatively poor enforcement regime is a fertile ground for concentrated shareholding to flourish”. Without more controlling shareholding power, it easily enables them to alter the memorandum or articles of association of a corporation without much hassle. Such a wide unhealthy empowerment may subject to abuse by the board to the disadvantage of the corporation which would usually lead to expropriation of minority interests.

Despite of the aforesaid flaws in the laws, it is highly commendable for the regulator to set out the roles and functions of a board in the Companies Act 1965. Nonetheless, it is equally important to clarify the perimeters of directors’ roles and duties in respect of managing and directing a corporation in whose interest. To transform the core nature of

directors' roles and duties, it should be supported by viable enforcement mechanism in which the spirit of *Corprimacy* may be upheld. In that sense, a proper understanding of *Corprimacy* may be constructive to set out the theoretical framework underlying directors' roles and duties which will in turn respond to the models of corporate governance – should a corporation be managed or directed in the best interest of the corporation (*Corprimacy* model) or for shareholder wealth maximisation (the shareholder primacy norm) or for the interests of stakeholders under the board's control (the director primacy model)?

Setting out the roles and duties of directors is in no way an easy task. There are a myriad of issues since different corporations have different system, cultures and responsibilities. The best string to tie up the different knots is the act of balancing the authority and accountability by directors. Such balancing act can be fine-tuned in the context of *Corprimacy* pertaining to the directors' duties and responsibilities.

#### **4.3.4.3. Duty of Reasonable Care, Skill and Diligence in the Context of *Corprimacy***

The law on the duties of directors can be traced back to the long established principles of director's duties in the common law position. In *Re City Equitable Fire Insurance Co Ltd* (1925) CH 407, it was held that “in discharging the duties of his position, a director must act honestly; but he must also exercise some degree of both skill and diligence”. The court added that there would be no breach of director's duties “so long as a director acts honestly he cannot be made responsible in damages unless guilty of gross or inculpably negligence in a business sense.” The rule is quite relaxed in the common law

as there is higher proof of gross negligence in a business sense in order to hold a director liable for his actions.

As regard to the duties of care, skill and diligence of a director in Malaysia, Section 132(1A) of the Companies Act 1965 clearly stipulates that “a director of a company shall exercise reasonable care, skill and diligence with (a) the knowledge, skill and experience which may reasonably be expected of a director having the same responsibilities; and (b) any additional knowledge, skill and experience which the director in fact has”. The new subsection 132(1A) introduces the test of objectivity and reasonableness into the standard of duty a director shall comply. Subsection 132(1A) can be divided into two limbs where the first limb (a) lays down the minimum expectation of duty from all directors based on the one’s knowledge and skill whilst the second limb (b) imposes a higher responsibilities upon those directors who possess additional knowledge, skill and experience. Thence, a director who professes himself as the expert or qualified specialist in a particular subject matter or area shall shoulder more duties and responsibilities than the general directors at large. They are reasonably expected to exercise higher standard of due diligence and care.

In discharging his duties, a director may also rely on information provided by others in reaching a decision. It is provided under Section 132(1C) of the Companies Act 1965 that “a director may rely on the information, professional or expert advice, opinions, reports or statements including financial statements and other financial data, prepared, presented or made” by the officer or person entrusted with the matter concerned. For all intents and purposes, it is impractical to leave all the management duties to directors to personally perform them. Particularly, there is great commercial need to delegate corporate powers and functions to the management body in large corporations. Hence, a

director must be able to reasonably rely on the information or expert opinions in arriving at a more holistic decision for the best interest of a corporation. The rationale of the aforesaid provision is also in tandem with the objective of *Corprimacy* where absolute corporate power would corrupt directors absolutely. For this reason, it is necessary to spread the corporate control over the business affairs of a corporation to the executives who are tasked with the daily management duties.

However, Section 132(1C) is not a provision that a director can simply rely upon in justifying his decision or action. This is because the reliance must be one that is made on reasonable ground. The deeming provision for a reasonable reliance can be found under the ambit of Section 132(1D) where it provides two requirements that first the reliance was made by a director “in good faith” and “after making an independent assessment of the information or advice, opinions, reports or statements, including financial statements and other financial data, having regard to the director's knowledge of the company and the complexity of the structure and operation of the company”. To ensure that *Corprimacy* is being pursued, a director has to reasonably believe that the officers of the corporation or any other professionals engaged will competently discharge their duties in the best interest of the corporation. Despite that directors may reasonably rely on the information provided, it is still pertinent for directors to be watchful and vigilant at the helm in overseeing the management as part of their governance role as well as supervisory function.

All in all, the significance of *Corprimacy* approach towards the fiduciary duties of directors are generally based on the principles of higher board accountability, balanced board authority with the management and shareholders, the best interest of a corporation and the business judgment rule which will be further discussed in chapter 5. Besides the

roles and responsibilities of the directors, the following section continues to harmonise the rights of majority shareholders and minority in a bid to uphold the concept of *Corprimacy*.

#### **4.3.5. Harmonising the Rights of the Majority and Minority Shareholders at the Crossroad of *Corprimacy***

A few decades ago, Jensen and Meckling (1976) had cautioned that the growing levels of ownership in corporations would engender the management to expropriate corporate capital to the disadvantage of minority shareholders. This is due to the fact that they have more control over the utilisation of the assets and liabilities as well as direct access to pertinent information about their corporations. Hence, they were of the view that such high level of ownership would then lead to increased risks of managerial entrenchment which is realised through the institution of a conforming board of directors, cross-shareholdings, participation in unfair related party transactions, redundant borrowings from different banks and excessive executive remuneration.

Furthermore, the rule in *Foss v. Harbottle* has unwontedly given birth to the “majority rule” which has then become a nightmare that haunted minority shareholder for centuries. Although the present company law in Malaysia sought to overcome the “majority rule” via the introduction of statutory derivative actions, it is very much to no avail in view of its post-remedial effect. The fact remains that such “principle of the supremacy of the majority rights of shareholders in a joint stock company” would mean that “a member has agreed to submit to the will of the majority provided that that will is



expressed in accordance with the law and articles of association” (per Raja Azlan Shah J in *Mooney & Ors v. Peat, Marwick, Michell & Company & Anor* [1966]<sup>21</sup>).

In this context, the oft-cited words of Lord Wilberforce in *Re Kong Thai Sawmill* (Miri) Sdn Bhd [1978]<sup>22</sup> are most instructive in illustrating the “majority rule” which overpowers the rights of minority. With regard to the remedy available for minority under Section 181(i)(a) of the Companies Act 1965, Lord Clyde in *Thompson v. Drysdale* required that “there must be awareness of that interest and an evident decision to override it or to brush it aside or to set at nought the proper company procedure”. In *Re Khong Thai Sawmill*, it is noted that the oppression rule has since been made more difficult for minority shareholders to seek remedy when their rights are prejudiced. The requirement of “a visible departure from the standard of fair dealing and a violation of the conditions of fair play which a shareholder is entitled to expect” is an unnecessary burden that will weigh down the success rate of minority in a case of oppression. It is definitely a gargantuan task to prove that the majority has the awareness of the minority’s interest and that they have evidently decided to override it. In this regard, this infamous case does not truly underscore the principle of *Corprimacy* where it is of utmost importance to harmonise the rights of majority and minority shareholders for the best interest of a corporation as a whole.

To make matter worse, the case of *Low Tien Sang & Sons Holding Sdn Bhd & Ors v. How Kem Chin & Ors* [1999]<sup>23</sup> has also further widened the gap of conflicting interests between majority and minority when the court reasoned that “it does not constitute oppression for those in control to insist upon the adoption of a policy on a matter of

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<sup>21</sup> 1 LNS 109.

<sup>22</sup> 2 MLJ 227.

<sup>23</sup> [1999] 1 LNS 163.

business on which there may be legitimate differences of opinion, nor is it oppression if an existing state of inequality results from the provisions of the constitution of the company and not from any action on the part of those in control”. The aforesaid case found its support in the earlier English case – *Re Harmer Ltd* (1959)<sup>24</sup> where Romer LJ said that “for a petition to succeed it must be shown that there has been oppression in a real sense of members qua shareholders, and not merely a subordination of their wishes to the power of the voting majority”.

It is not uncommon to find scholars arguing on the issue of conflicting interest between minority and majority shareholders. Some would champion the rights of minority shareholders while others would promote the rights of shareholders as a whole. At this very juncture, the baffling issue remains whether shareholders wealth should be maximised as an en bloc or corporate objectives and interests should take priority. If shareholder primacy norm prevails, the next question arises – to what extent will the shareholder wealth be maximised as an en bloc? In practice, controlling shareholders who are usually the majority have louder voice and final say in the sense that their voting powers are stronger than minority. It seems that majority shareholders control the “en bloc” and indirectly represent the voice of the “en bloc”. Consequently, it is highly likely that the interest of minority will often be prejudiced in which they would reap the least benefit, or worse still, suffer losses at their own peril.

Such dilemma is as a result of the differences in opinions pertaining to the diverging definition of primacy and the principles that define these norms. The greatest hurdle here is to reconcile the variance in applications in order to iron out the unresolved issues and find a common theme among these issues. Supposedly, a sound corporate

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<sup>24</sup> (1959) 1 WLR 62.

governance framework should have considerable room for the protection and preservation of legitimate interests of minority shareholders. This is simply because majority shareholders often defy minority shareholder rights by initiating steps to assert their authority over a corporation with the evil intention to dwindle the standings of minority against them.

In a nutshell, the objective of *Corprimacy* is to harmonise the rights of majority who mostly sit on a board and that of minority shareholders who mostly remain outside of the board. It seeks to strike a balance between two extremes in order to reach an axis point where a corporation can sail smoothly as an entity in general. The balancing scale involves the participation of all relevant stakeholders within a corporation to realise the objective of *Corprimacy* – best interest of the corporation. Hence, this dissertation aims to formulate corporate governance best practices that can be adopted to afford the minimum protection to minority shareholders based on the model of *Corprimacy*. It should be borne in mind that the formulation of the corporate governance best practices is not sustainable without active shareholder activism.

#### **4.3.6. Enhancing Shareholder and Investor Activism Through the Sustenance of *Corprimacy***

Sustaining *Corprimacy* constitutes a means towards enhancing shareholder and investor activism in the long run. It should not merely be perceived as an ends itself since the level of shareholder and investor activism greatly depends on the continuing application of *Corprimacy* within a corporate entity. Perhaps, shareholder activism may stem from the mistrust and scepticism in the wake of recent corporate scandals where most of shareholders have started to lose faith in the board. Theoretically, the conventional

shareholder primacy would suggest that directors should manage or direct the business and affairs of corporations on behalf of shareholders who are the owners of the corporations.

Unknowingly, this common perception has given rise to a lower shareholder activism as they tend to rely heavily on the directors' duties to manage a corporation in their best interest. Such passive reliance has led to increased control of a corporation by directors who often do not live up to their expected responsibilities. In Malaysia, it is common that shareholders with controlling stakes are often actively involved in the management of the businesses as they need to take care of their substantial interest of ownership in a corporation. Hence, this dual identity of owner-manager relationship triggers more unwelcoming opportunities for controlling shareholders to expropriate the interest of minority shareholders.

In this regard, it is of utmost importance to implement a set of corporate governance best practices which is corporate-centric in nature. Having the *Corprimacy* model, it is highly likely that controlling shareholders would endeavour their best to align their interests with those of minority shareholders as the corporate interest would always be put in top priority. For the benefit of a corporation, controlling shareholders will have to take into consideration the interest of a corporation as a whole whilst making any decision or taking any corporate action. This is due to the push factor of *Corprimacy* that motivates them to enhance the performance of their corporation for the best interest of the entire corporation. Simply put, the advancement of the corporate interest will in turn result in the increased corporate value or performance that will benefit all stakeholders of a corporation in the long run. Such interest-balancing act would further encourage minority shareholders to actively participate in the management of a

corporation in order to be better equipped with the knowledge of the past, present and future activities of the corporation in which they have invested.

As a result, a board will no longer be dominated by controlling shareholders only as minority shareholders would also vigorously call for their representatives to be elected to the board. This will help to create a more balanced board composition where a check and balance mechanism can be set up as an internal control of the board's decision. In an effort to make a board aware of and more responsive to their interests, they may also regularly submit proposals to the board for proxy solicitations and convening general meetings to decide on a particular transaction. Hence, it is clear that the enhanced shareholder activism would render the corporation action undertaken by directors to be closely scrutinised by shareholders. Dent (2008) argued that "shareholder control would not be perfect - no system dependent on human beings can be - but it would be far better than the CEO-dominated boards we have now". It is also not evidently proven that more shareholder control would provide a better governance mechanism to a corporation, especially a corporation who has a CEO-dominated board. Be that as it may, there is an ardent need to enhance the shareholder activism in order to add to the frail shareholder control over large corporations as shareholder activism can be an important tool to reconcile the "competing interests of corporations and society" (Monks, 2007).

Moreover, the active involvement by institutional shareholders or investors forms an integral part of shareholder activism as it basically reflect that board's decision is under effective scrutiny to ensure higher level of accountability amongst directors. Institutional shareholders may also intervene into board's actions when corporate performance is declining as well as exercise voting power to push for a transformation in corporate policies or change in the management team. Based on the crux of

*Corprimacy*, institutional shareholders may play their vital part as the watchdog for the corporate actions or decisions made by board and management. To a certain extent, such activism would divest the total control and power of board and management in which the institutional shareholders would share the role and function of governing and managing the corporation. In this context, the mounting shareholder activism by institutional investors in changing the governance structure of hedge funds has been so remarkable that “the record supports the proposition that they have shifted the balance of corporate power in the direction of outside shareholders and their financial agendas, perhaps heralding a modification of the prevailing description of a separation of ownership and control” Bratton (2006). This follows that increasing shareholder activism can lead to the erosion of “director primacy” which finds its basis on the separation of ownership and control.

In the current challenging corporate world, directors should be prepared to allow shareholders, especially minority shareholders as well as other investors to actively play a significant role in governing corporate practices. A study has been conducted by the Oxford Analytica (1992) on the G7 Countries’ Board Directors and Corporate Governance, the report showed that corporations will have to give investors more of a role in governance in order to compete for capital (Monks & Minow, 1995). Undeniably, the outcome of the report exemplifies the very cornerstone of *Corprimacy* where every constituent or corporate player within a corporation has a collective and interdependent role to play to preserve and enhance the best interest of a corporation as a whole.

In conclusion, shareholders and investors may not be directly involved in the day-to-day management of a corporation as they are not supposed to be the managers of the corporation. Be that as it may, the greater need for activism on their part to participate in

the governance processes directly could not be easily ignored or brushed aside by the board as the concept of *Corprimacy* will flourish with the high shareholder and investor activism. Needless to say, the enhanced coordination among various investors and shareholders can assist a board in reaching a more comprehensive quality decision that considers all factors affecting a corporation. It is also important to protect the interest of a corporation including minority shareholders when corporate reputation and survival are at stake. Illustration 4.7 below highlights the correlative relationship between the enhancement of shareholder activism and the reduction of minority oppression.

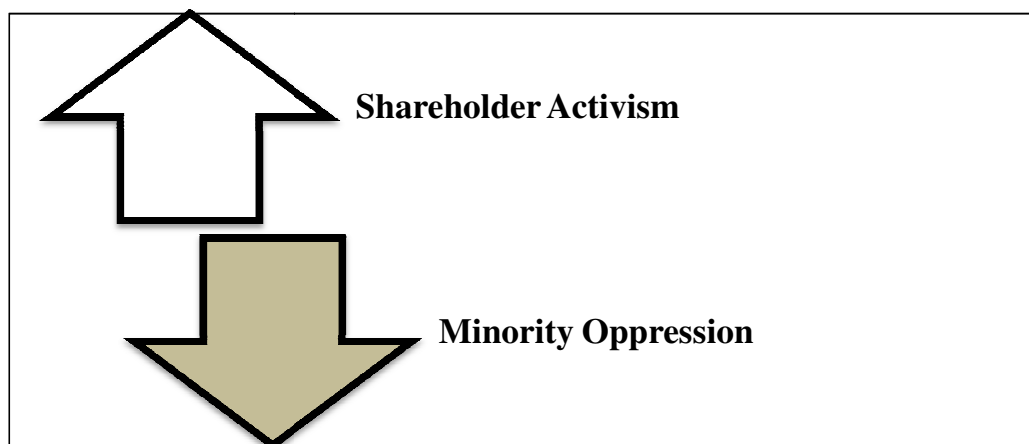


Illustration 4.7: Correlative relationship between the enhancement of shareholder activism and the reduction of minority oppression

#### **4.4. *Corprimacy* – Recent Case Studies**

The foregoing discussion on the concept of *Corprimacy* is not complete without a closer look at some of the remarkable case studies in Malaysia. These case studies are in relation to the board tussles in Petra Perdana Berhad (“Petra Perdana”) and the Ho Hup Construction Co Berhad (“Ho Hup”) where the application of *Corprimacy* could have

been instrumental in improving the corporate governance best practices of both the corporations.

#### **4.4.1. Board Tussle in Petra Perdana**

On December 2009, Petra Perdana disposed 25.03% of Petra Energy to ease its bank borrowings by about RM150 millions with a residual cash balance of about RM116 millions as well as to accelerate Petra Perdana's fleet expansion and renewal programme. The corporation also planned to divest the remaining 29.59% stake held in the latter. However, former executive director of Petra Perdana, Shamsul Saad who is currently the company's new managing director, had filed and obtained court injunction to stop the sale of remaining 29.59% shares in Petra Energy. He challenged the move of the company on the basis that "the conditions set by the board were not met, namely, that the sale should be conducted en bloc and on an open tender basis. The en bloc condition inherently already requires shareholder approval in an extraordinary general meeting". He added that "to execute this share sale piecemeal without reverting to the board undermines the requirements for shareholder approval". It was also claimed that the sale was at more than 12% discount where "it breached the shareholder mandate of not more than 10% discount". (The Star Biz News, January 2010).

On 9 February 2010, the Star Biz (2010) news reported that the former Executive Chairman and Chief Executive Officer of Petra Perdana, Tengku Datuk Ibrahim Petra "has exercised his executive powers to temporarily suspend senior management and key personnel of the company until Feb 3". Tengku Datuk Ibrahim Petra reasoned out that "this action (suspension) has nothing to do with vendetta, as some may perceive. Every shareholder has the right to invoke Section 145 of the Companies Act if the board fails



in its functions”. Apart from that, he was also reported of claiming that “instead of jointly supporting the board’s efforts to uphold the company’s image and manage its challenges, the senior management and key personnel chose to look the other way and use the opportunity to pursue their own agenda in seeking board representations in the company”.

Due to the dissatisfaction over the sale of 25% stake in Petra Energy, Shamsul Saad and another 10 shareholders of Petra Perdana had subsequently called for an extraordinary general meeting on 4 February 2010 to remove four directors including Tengku Ibrahim Petra and his wife, Datin Nariza Hajjar Hashim as well as two other independent non-executive directors. In an attempt to relinquish the rights of the then suspended directors to call for the extraordinary general meeting by Tengku Datuk Ibrahim Petra, the fact remained that their removal did not prevent or stop the suspended directors from requisitioning an extraordinary general meeting as of shareholders rights. They argued that “we are still shareholders. The suspension is pertaining to our employment and it does not change shareholders’ rights. We are doing things merely to uphold minority shareholders’ rights and for the good of the company.” As a result, the special meeting witnessed the removal of Tengku Datuk Ibrahim Petra as the Executive Chairman and Chief Executive Officer of Petra Perdana.

In the beginning of 2009, the share price of Petra Perdana was floating around at the level of RM 1.20. Following the big bull trap of rising stocks, it once reached the level of RM 3.14 on 15 June 2009. However, this high level of share price did not hold long as it began to fall following Petra Perdana’s sale of 25% stake in Petra Energy Bhd (“Petra Energy”) – a subsidiary of Petra Perdana broke out to the public. As minority shareholders did not realise about the underlying problem behind the sale, they

helplessly ignored the alarming signal which persisted till the occurrence of share slump and the revelation of disputes within the management of the corporation. In relation to the sharp fall in share price, the Chief Executive Officer of MSWG, Rita Benoy Bushon also commented that “minority shareholders stood to suffer the most in the ensuing battle between the two sides, with the long-term vision of the group now blurred and in disarray” and it “could have a negative impact on earnings as well as the share price, until the issue is resolved” (The Star Biz News, January 2010). Hence, it seemed that a fast end to the tussle would benefit minority shareholders as the dispute between the two camps might affect the company’s fundamentals, in particular its operational and financial performance.

It was noted that the resolution to remove the four directors was largely depending on the votes by minority shareholders since each of the two rivals collectively own 12% to 15% of Petra Perdana. It reflected the significance of shareholder activism led by minority shareholders in transforming the management and governance structure of a corporation. The role of an institutional investor may not be undermined as well in light of the fact that Lembaga Tabung Haji and Permodalan Nasional Bhd collectively hold 16% stake while Amanah Saham Wawasan 2020 holds another 7.6%. As such, it could be seen that the united strength of the institutional investors and minority shareholders would generate a forceful power that may move any changes in a corporation.

#### **4.4.2. Ho Hup Construction Co Bhd**

Ho Hup was once a gigantic construction and engineering corporation that laid hands in the building of the Petronas Twin Towers, National Sports Complex, and Kuala Lumpur International Airport. However, the sale of two parcels of land which were owned by

Ho Hup has sparked off the burning battle between Ho Hup's former managing director, Lim Ching Choy and Ho Hup's substantial shareholder and current managing director, Datuk Low Tuck Choy who owns another company named Low Chee & Sons Sdn Bhd which had founded Ho Hup. It was alleged that the two parcels of freehold land were being sold at below market rates. On top of that, Datuk Low Tuck Choy also claimed that the regularisation plan submitted to Bursa Malaysia to lift Ho Hup's Practice Note 17 (PN17) status was not "in the best interests of minority shareholders."

In a similar twist with the Petra Perdana's board tussle, two substantial shareholders of Ho Hup, Low Chee & Sons Sdn Bhd and Choo Soo Har had also called for the extraordinary general meeting on 4 February 2010 to remove 8 out of 9 directors including Lim Ching Choy in order to give way to the appointment of 6 new directors. The extraordinary general meeting was considered as the forum for shareholders to decide on the fate of the corporation in such as tense conflicts. However, the extraordinary general meeting was not held as scheduled on 4 February 2010 due to the injunction order obtained by Ho Hup's controlling shareholder Extreme System Sdn Bhd in bringing the meeting to a halt. The High Court granted the order on the technical ground that the notice of the said meeting was "one day short of the 28-day notice period as required under the law". Notwithstanding this, the extraordinary general meeting managed to be requisitioned on March 17 where some 55.94% of shareholders voted for the removal of Datuk Vincent Lye, Lim Ching Choy, Datuk Liew Lee Leong, Long Mohd Nor Amran Long Ibrahim, Mohd Shahril Hamzah and Foo Ton Hin.

Arising out of rancorous board tussle, the then board of Ho Hup had also decided to enter into a joint development arrangement with Pioneer Haven Sdn Bhd ("Pioneer Haven") which is a wholly owned subsidiary of Malton Bhd to develop a piece of 60-

acre land in Bukit Jalil via Ho Hup's subsidiary, Bukit Jalil Development Sdn Bhd ("Bukit Jalil Development"). The large 60-acre land is a substantial asset belonged to Ho Hup. From the arrangement, it appears that it is in the best interest of the corporation to develop the land for the purpose of projecting the revenue of Ho Hup. It is noted that the unprofitable arrangement did not require any Ho Hup's shareholder approval to be concluded with Pioneer Haven since it did not involve transfer or disposal of a substantial property of the former. As such, the aforesaid board decision was legally correct as it has not contravened any provision under the Malaysian company laws.

Supposedly, there is nothing unusual or wrong about the said decision. Nevertheless, a closer perusal of the terms of the deal raises the question whether the decision was actually made in the best interest of the corporation based on the industry practice and acceptable according to common business sense. Although the terms stipulate that all cost would be borne by Bukit Jalil Development and Ho Hup as the parent corporation, there was an obvious unbalanced or disproportionate entitlement of profits granted to Bukit Jalil Development which would only be entitled to 17% profit subject to a minimum entitlement of RM265 millions in return. This agreed terms were grossly unreasonable in the business sense in view of the expected sales revenue of billions in value over a period of 10 years. What added up to the unreasonableness was that the owner of the land – Ho Hup was entitled to a significantly low profit as compared to the developer of the land.

In the Bursa announcement, the then board of Ho Hup merely stated the rationale that "in the absence of any refinancing options, the entry into the joint development arrangement presents a viable alternative to restructure the amount owing to the existing charge and avoid foreclosure of the land." From this statement, it could be reasoned that

the main purpose of the deal was to avoid the foreclosure of the land by irrevocably authorising Pioneer Haven to retain the original document of title of the land until subdivision. At one hand, the rationale seemed to be heroic in securing the asset of the corporation from being foreclosed. At the other hand, the deal was done at the expense of the best interest of the corporation. In the long run, the corporation would suffer substantial reduction in prospecting earnings which would in turn greatly affect the shareholder value. In addition, the decision was made in a hasten manner by the then board of Ho Hup a day before the change of boardroom which was passed through by an extraordinary general meeting initiated by the current board. Hence, it was a dubious deal when the then board of Ho Hup has anticipated the possibility of their removal during the meeting next day. There may be the intention of sabotage done to the corporation in such a revengeful situation.

As explained above, it is imperative that the then board of Ho Hup should have disclosed to the Bursa and the public pertaining to various factors that they have considered in justifying that the deal was in the best interests of Ho Hup by going beyond mere statement of “best interest of the corporation and its shareholders”. It was uncertain as to whether the entitlement to a minimum amount of RM 265 millions was intended to cover all or part of the costs in acquiring the 60-acre land or for other ulterior purpose only know to the then board. Such uncertainties could have been clarified if the then board of Ho Hup has provided some explanation in coming to the said agreed term. Without deep entrenchment of ethical value in the governance system, it seems that the directors of the then board had washed their hands to swiftly flee from the irresponsible deal concluded by the entangled corporation, at least, in term of legal sanction.

#### **4.5. *Corprimacy* – The New Way Forward in Malaysia**

Recently, the corporate community has witnessed that the local regulatory approach is gradually shifting towards *Corprimacy* norm in setting the corporate governance standards with the ultimate objective of protecting minority shareholders. The *Corprimacy* approach is evident in the latest amendments of the Malaysian Capital Markets and Services Act 2007 via the Capital Markets and Services (Amendment) Act 2009. A new Section 317A was introduced in the Capital Markets and Services Act 2007 to empower the Securities Commission Malaysia to take action against those directors or officers who intentionally cause wrongful loss to the public-listed corporations. Subsection (2) of the provision states that “this section is in addition to and not in derogation of any law relating to the duties or liabilities of directors or officers of a listed corporation”. Hence, it is understood that the new provision seeks to lift the corporate governance standard in relation to the duties and liabilities of directors as well as other officers in a corporation. It is intended to discourage directors and officers from engaging in unethical conducts or making irresponsible decisions that may be detrimental to a corporation. In this regard, the duties and roles of directors and officers must be aligned with the interest of a corporation as a whole. The new provision only prohibits conducts of directors or officers that cause wrongful loss to a corporation and not to shareholders per se. Hence, it reaffirms the cornerstone of *Corprimacy* which places the best interest of corporation as the primary or superior consideration over other interests. Most regulators garner their lessons not from corporate governance principles or corporate performance figures but from historical corporate failures. Being the capital market regulator, the laudable move of the

Securities Commission Malaysia has further substantiated the need for the adoption of *Corprimacy* as the new concept of corporate governance in Malaysia.

#### **4.6. Conclusion**

In short, *Corprimacy* may reflect a better picture of interaction within a corporation itself. Corporate governance best practices should not be heavily geared towards the interest of a board since the effective implementation of the goals set by the board will ensure that the “business judgment rule” is exercised in the best interest of the whole corporation in the long run. For instance, the Star Business News (Mac, 2010) also reported that following the recent financial crisis, many countries have prioritised corporate governance as their key reform agenda in which the ensuing corporate governance standard adopted for financial institutions are built on the following key tenets:

... clear separation of management and oversight functions, adequately competent and committed boards, presence of a strong independent element on the board, and a clear, explicit and dedicated focus on the oversight responsibilities of the board for risk, internal controls, remuneration, and directors and management performance and succession.

To sum up, the Malaysian corporate governance bar can only be raised if every corporate player in the capital market plays each role in complying with the form and substance of the corporate governance best practices. Nik Ramlah Mahmood (2010), the Managing Director of Securities Commission Malaysia has rightly addressed the underlying theme of *Corprimacy* which can become the means and ends of corporate

governance. It was explained that the corporate governance bar can be raised via “oiling the basic legal requirements with high doses of ethics, integrity and morality”.



## CHAPTER 5

### CRITICAL DISCUSSION:

#### FORMULATION OF CORPORATE GOVERNANCE BEST PRACTICES

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##### 5.1 Introduction

The discussion in Chapter 4 reveals that the Malaysian corporate law regime favours the notion of *Corprimacy*. This is apparent from the approach taken by the Malaysian High Level Finance Committee on Corporate Governance that corporations should be managed “with the ultimate objective to enhance long term shareholder values, whilst taking into account the interests of other stakeholders” (*Report on Corporate Governance*, 1999). In other words, best interest of a corporation should encompass the interest of all members and stakeholders of the corporation as a whole. This is akin to the *Corprimacy* notion which will guide the formulation of corporate governance best practices in relation to the main theme of this dissertation – the protection of minority shareholders.

From the international perspective of corporate governance, Cheffins (2009) elaborated on the evolving development trend in the United States where he identified few significant attributes of a “shareholder value model” such as independent directors, shareholder activism and performance-based compensation. It is important that Malaysia should step up corporate governance best practices by focusing on the abovementioned attributes of “shareholder value model” as advocated in the United States. Such attributes are akin to the main theme of this dissertation – the protection of minority shareholders. Therefore, this chapter will emphasise on the corporate

governance best practices that create, preserve and deliver values to a corporation with the vision of protecting minority shareholders in the long run. This is due to the simple analogy that the best interest of a corporation is positively correlated with the interest of minority shareholders.

Since *Corprimacy* requires that minority interest be aligned with the best interest of a corporation, this chapter is divided into several important sections in order to collectively formulate a set of corporate governance best practices with the aim of protecting the interest of minority shareholders. The first section will deal with the different potential conflict of interests in a corporation and best practices that may minimise such conflicts. It will then continue with the discussion on the importance of board disclosures and transparency issues. The remaining sections will propose best practices such as board independence, enhanced shareholders' rights and powers as well as a higher level of board accountability. The results of this formulation is succinctly summarised in the final chapter of this dissertation.

## **5.2 Dealing with Conflicts of Interests within a Corporation**

In paving the path to a better corporate governance system, it is necessary to examine the question of what ends a board should seek to achieve in their decision-making process. The ends will determine what means to be devised in achieving the desired result of protecting minority shareholders. It is suggested that directors should formulate their decisions based on the primary interest of their shareholders or in the best interest of a corporation. As can be seen from Chapter 4, some argued in favour of shareholder's interests as directors are mere stewards of their interests. On the other hand, some

championed for the idea that directors should have absolute decision-making power in maximising shareholder wealth.

Regardless of what these scholars views are, chapter 4 has made it clear that the interest of all stakeholders within a corporation should be the primary concern in relation to corporate governance best practices. *Corprimacy* does not confine the best interest of corporation to dealing with conflict of interest between directors and shareholders per se. But it extends beyond the narrow interpretation of corporation to include the conflict of interest with all other members and stakeholders of a corporation like creditors, employees, suppliers and management as well. As such, every constituent of a corporate entity has vital role to play in making sure that the best interest of a corporation is being upheld by the board. To do so, shareholders, especially minority shareholders need to be equipped with stronger power and voice to achieve the ultimate objective of governance best practices. This best practice will be further explained in Section 5.9 of this chapter.

However, conflict of interests may sometimes sway directors away from their fiduciary duties of loyalty to their corporation. Pertaining to this limitation of fiduciary duty in the event of conflicts, Scott (1998) described that conflicts of interest may arise in situations where there is excessive compensation, misappropriation of corporate fund or worst still siphoning of corporate wealth by the managers themselves. The mushrooming of these conflicts of interests will lead to the constant restraint of directors' duties when personal interest overshadows the interest of corporation and shareholders. This was exactly what happened in the Enron or Transmile case in which financial misstatement was the main root cause of corporate downfall. To avoid sharp fall in share price, the directors of Enron decided to take matter into their own hands via inflation of financial figures at a large magnitude. When the corporate malpractice unfolded, the biggest loser

remains minority shareholders who had no chance to exit from the corporation. Thus, the study of corporate governance best practices should begin at the doorstep of identifying different conflict of interest before ascertaining the directors' duties. Illustration 5.1 below is more accurate in outlaying the directors' duties to avoid conflict of interest in public-listed corporation where shareholder base is opened to the public at large. Minority shareholders are most vulnerable in the governance structure and system of these large public corporations due to its diverse conflict of interests. That is the reason why this dissertation only discusses on the protection of minority shareholders in public-listed corporations.

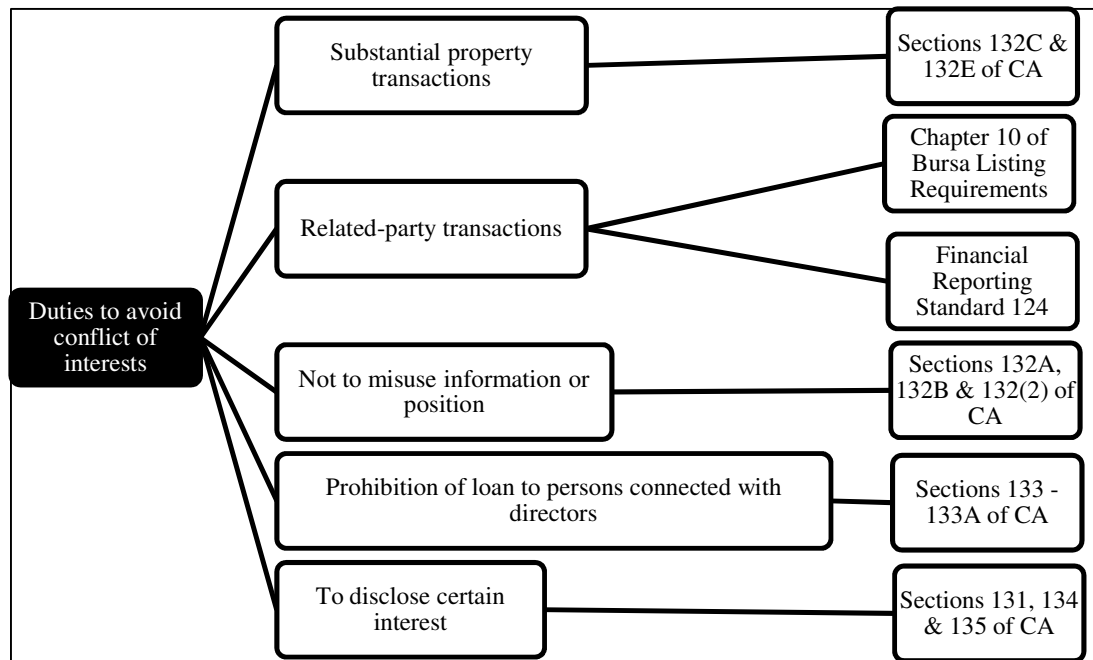


Illustration 5.1: Statutory duties to avoid conflicts of interest

Apart from the director's statutory duty to avoid the conflicts of interest above, potential conflicts of interest such as those in a related-party transaction may also exist within a corporation due to its complex organisational structure and nature of business (as shown in Illustration 5.2 below). It is a fact of corporate life that is hard to be ignored and

denied. Hence, a director must not only learn how to identify the conflicts of interest that may take place but also to recognise the risk exposed from such conflicts. To recognise such a risk, directors should understand the types of conflicts that a corporation faces internally. For this, it would not be effective if a corporation does not have a sound corporate governance system that could actually enable directors to quickly identify and resolve the conflicts. Despite of its importance, the Companies Act 1965 is silent as to how should a director or board address the different conflicts of interest which may arise within a corporation. This is a delicate situation which requires a proper internal control mechanism to be put in place in order to facilitate a board's decision-making process. This best practice of sound internal control system is discussed in-depth at section 5.10 of this chapter pertaining to risk management and audit process.

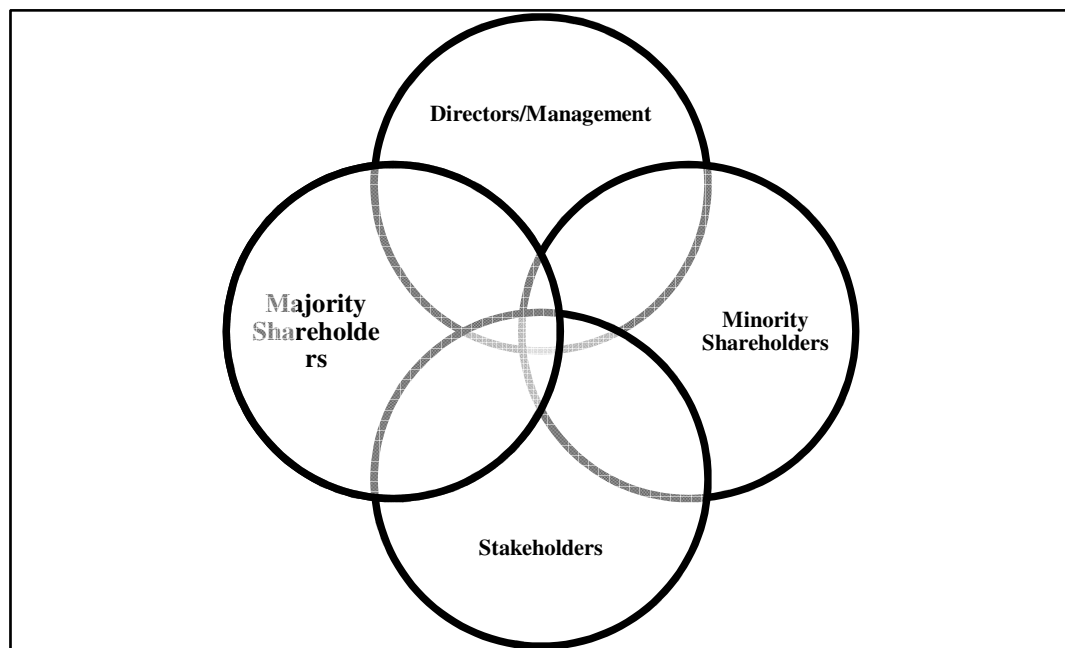


Illustration 5.2: Potential conflicts of interests in a corporation

At times, conflicts of interests may arise when directors or management representing majority shareholders seek to use company resources to acquire assets or other corporations that are not associated with the core business activity of a corporation or are indirectly related to directors or majority shareholders. In an announcement to the Bursa Malaysia (25 November, 2005), AKN Technology Berhad (“AKN”) had entered into an agreement to acquire 100% equity interest Paramount Discovery Sdn Bhd (“Paramount”) and its subsidiary companies at a purchase consideration of RM 30.8 million. The acquisition appeared to have nothing unusual on its face of transaction. Although it was not a related-party transaction, the acquisition itself was rather questionable – the core business activity of AKN is principally in the semi-conductor industry while Paramount is involved in the rubber glove coating business. The business activities of the two companies are entirely different to the extent that it raised considerable doubt with regard to the motive behind the acquisition. Therefore, it does not make commercial sense for directors to engage in any transaction that is not connected with the corporation’s core business activity. In other words, directors must be able to identify the potential conflict of interest with their current core business activity as a result of such contradictory commercial interest. At the end of the day, minority shareholders will be the ones who face the risk of losing their entire investment should the conflicting business interest cause the corporation a great fortune.

Hitherto, various mechanisms had been employed to align the interests of management to shareholders, such as profit sharing, efficiency wages, and performance measurement including financial statements, stock options as well as the threat of firing. Since the introduction of Sarbanes-Oxley Act in the United States, Zabihollah Rezaee (2007) rightly highlighted “commitment to the highest ethical standards” as the objective of good corporate governance to avoid potential conflicts of interest in a corporation. This

is where board ethics comes into play as a tool for avoidance of potential conflict of interest. Board ethics is further addressed in section 5.8 of this chapter in moving towards a holistic corporate cultural reform. All in all, the discussion on conflicts of interest in a corporation is never satisfactory without further examination on some case studies in the real life situation. The ensuing section embarks on some interesting twist of events in related-party transactions in Malaysia.

### **5.3 Case Studies for Conflicts of Interest in Related-Party Transactions**

The focus is thrown on the related-party transaction since it is widely touted as one of the most common cases leading to conflicts of interests between board and shareholders. Such transactions often culminate in unfavourable losses to minority shareholders. The case studies shown below testify for the result of inevitable conflicts of interest and how a director should practice good governance in managing these cases.

Generally, corporate ownership of a typical Asian corporation is likely to be concentrated in a single group – a family or the State. The majority of corporations in South East Asian countries are controlled and managed by family members (Claessens, Djankov and Lang, 2000) except that State-ownership model is more likely to be seen in communist country like China. In Malaysia, it is very common that many family-dominated corporations use the related-party transactions or special purpose vehicles as a tool to expropriate wealth from minority shareholders. This is due to the structure of family-dominant control that makes it easy for related-party transactions to take place, in particular when some of the entities complement or exist to sustain and facilitate the operations of one another.

The senior management and board positions in these family-controlled corporations are often occupied by family members and close allies or proxies. Due to muddled dividing line between ownership and management in corporate structures, it is more likely that any related party transaction can be easily tainted with conflicts of interest that could short-change unwitting investors. For instance, a public-listed corporation could channel its surplus cash to its unlisted parent for an indefinite period, denying itself and its minority shareholders the opportunity to generate higher returns through strategic investments. Worst still, a corporation could purchase assets and liabilities from an unlisted affiliate at an inflated price – an obvious means of siphoning away the wealth of a public entity into the private interests of the same controlling shareholders. Ryngaert and Thomas (2007) noted that directors and officers are considered to have involved in related-party transactions when they entered into contracts with their “relatives, large shareholders, other firms that the officers and directors are affiliated with, or even with themselves” to lease, acquire, purchase, dispose of the assets of the corporation as well as in employment matters. It was added that these contracts are most often favourable to the related parties involved. As such, the desired wealth maximisation in related-party transactions eventually belongs to controlling shareholders who are either directors themselves or represent the directors.

In respect of the most prominent type of related-party transactions, it covers “loans to related parties; payments to company officers for services that were either unapproved or non-existent; and sales of goods or services to related entities in which the existence of the relationship was not disclosed”. The pattern of cash flow was explained in the context of corporate fund embezzlement and misleading financial statement. The inflow of cash into a corporation is usually connected to the former whereas the outflow of cash from a corporation is related to the latter. Whilst finding that related-party



transaction was the key feature of fraud, they gave the example of “fictitious sales” being used as mechanisms for tunnelling of corporate fortune to a related party on the pretext of such non-existent sales (Henry, *et al.*, 2007). These pose as red flags for fraudulent act or mala fide on the part of directors involved in related-party transactions. As such, it is very important for board or management to recognise these red flags before it is too late to save a corporation from reaching verge of destruction.

The involvement of directors in a related-party transaction inevitably will affect the value of their corporation. Empirically, a study of corporations in China found that the more often a corporation engaged in related-party transactions, the lower its firm value (Liu & Lu, 2004). Corporations that provide loans to their related parties also received lower market valuations than those corporations that either minimised or avoided the practice entirely (Jiang, Yue, & Lee, 2005). Moreover, public-listed corporations in Hong Kong also faced “negative abnormal stock returns” by simply making an announcement of a related-party transaction. These findings suggest that related-party transactions could negatively affect the shareholder value although the transactions are not necessarily abusive (Cheung, Rau & Stouraitis, 2004). In the United States, Gordon, Henry, and Palia (2004) also found that those corporations that involved in high volume of related-party transactions are more likely to show evidence of “weaker corporate governance practices.”

In a related party transaction, the Business Times (16 December, 2009) reported that “Genting Malaysia bought two firms which own the 25-storey Wisma Genting and two parcels of land in Segambut for RM228.6 million from its parent, Genting Bhd”. It was also reported that “it did not need to get the approval of shareholders or regulators for the purchases as the price did not exceed 5 per cent of its shareholder funds”. The

corporate action was criticised by Rita Benoy Bushon that “given the dominant board structure, common major shareholders and common directors in related companies involved in the proposals and the absolute cash amounts involved, the proposed acquisitions ought to be put to non-interested shareholders for a vote by minority shareholders of Genting Malaysia even though the rules stipulate a higher threshold”. Such comment speaks of the importance of giving the right to minority shareholders to vote or at least have some say in any related party transaction regardless of its value of transaction. Even though the acquisition undertaken by Genting Malaysia may raise red flags of corporate fraud, it does not necessarily mean that the related-party transaction involves any element of fraud or creates harmful implications to shareholders. However, it does create opportunity for directors to abuse such related-party transactions to commit fraud in disguise in order to gain personal interest.

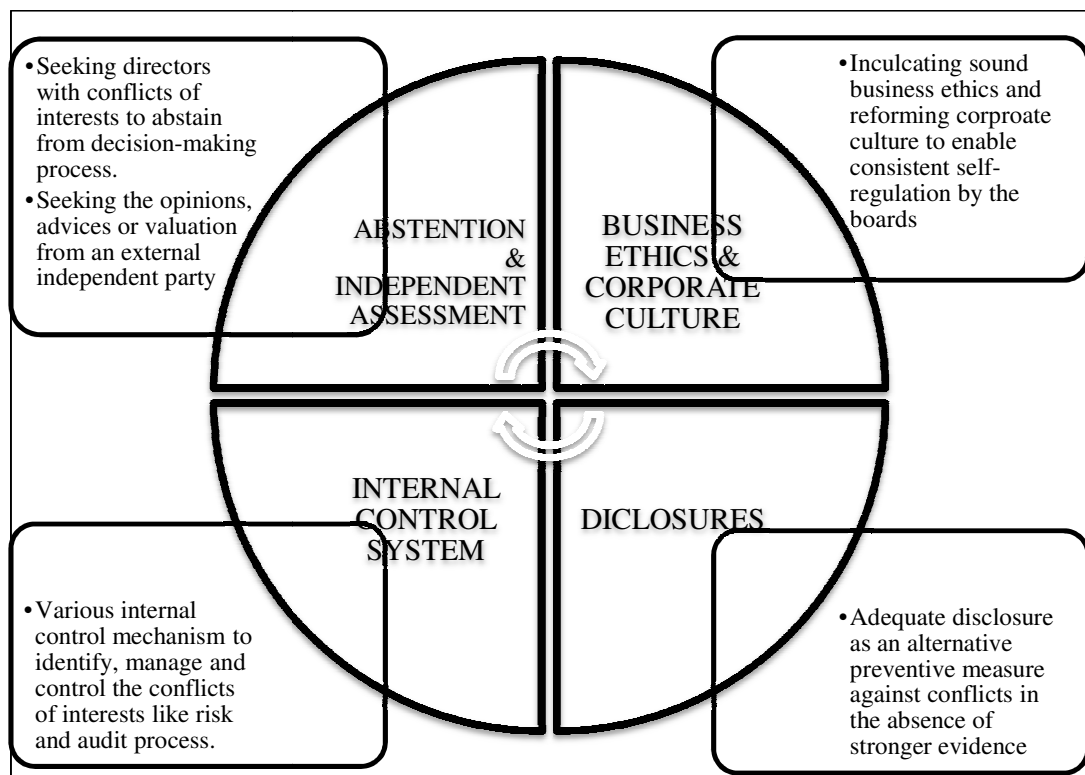


Illustration 5.3: Dealing with conflicts of interests

To sum up, the inherent risk of facing conflicts of interests in a corporation is nigh impossible to be eliminated since conflicting interests will never end so long as it contradicts the personal interest of a director. In dealing with conflicts of interests in a corporation, the best practices can be best summarised in Illustration 5.3 above. What needs to be done is that minority shareholders ought to be protected from any undesirable consequences arising from such conflicting interest. In relation to this, section 5.9 of this chapter discusses some of the best practices to enhance shareholder's rights and powers in decision-making process in view of the potential conflict of interest arising within a corporation.

#### **5.4 New Board Disclosures and Transparency**

Undeniably, corporate governance is all about disclosure of any interest that a director may have in his corporate dealings to a corporation as well as disclosure of information to shareholders. Mallin (2002) highlighted that “information to shareholders is one of the most important aspects of corporate governance, as it reflects the degree of transparency and accountability of the corporations towards its shareholders”. Knowing the importance of disclosure requirement, Cadbury (1999) believed that “the foundation of any structure of corporate governance is disclosure. Openness is the basis of public confidence in the corporate system and funds will flow to centres of economic activity that inspire trust”. Shareholders must be able to put their complete trust upon a board to represent their interest. It is necessary to develop a strong foundation of trust and confidence in corporations by way of frank disclosure and open policies.

Without sufficient disclosure, directors may hide negative financial results or information from the public, especially shareholders for fear of dropping of share price. On the opposite side of the same coin, directors may also use the sensitive information of a corporation to their advantage by manipulating the share price of the corporation. Seligman (1983) viewed that “in the absence of a compulsory corporate disclosure system some issuers will conceal or misrepresent information material to investment decisions.” Most often than not, shareholders and investors may not judge the decision made by directors as they do not have direct access to material information in a corporation. But this “information asymmetries” should not be allowed to compromise the very corporate governance principle that speaks of corporate disclosure of information to shareholders and other relevant stakeholders. This principle of disclosure rests on *Corprimacy* norm that shareholders have legal rights to access information in a corporation. This reflects the mandatory requirement of corporate disclosure system implemented in the Malaysian corporate scene.

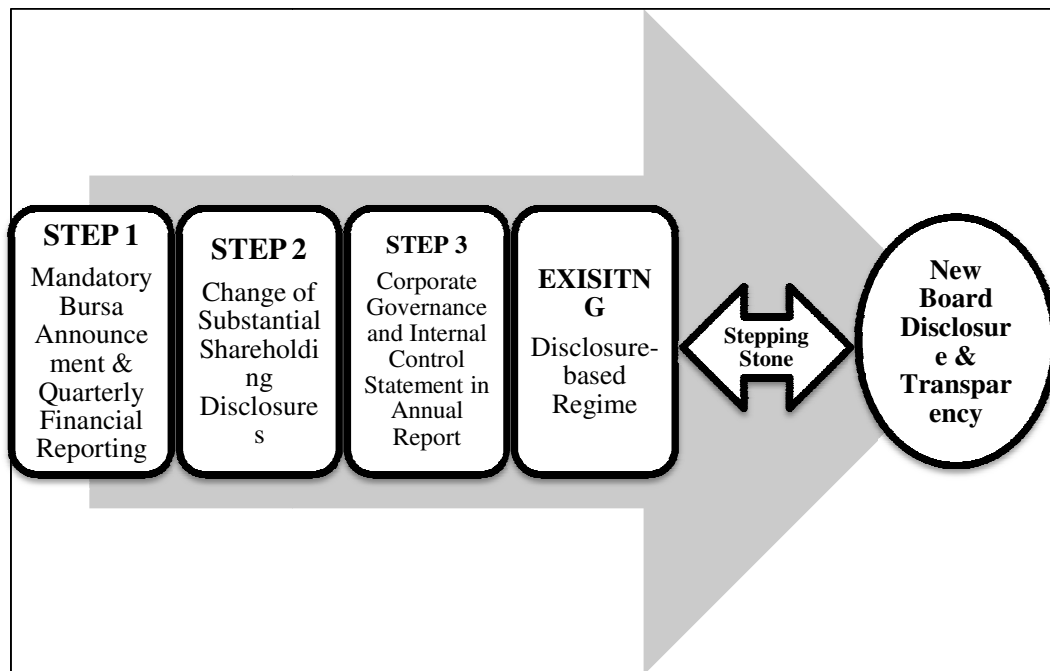


Illustration 5.4: Existing disclosure requirements towards disclosure-based regime

The Illustration 5.4 above spells out the existing disclosure requirements for public-listed corporations in Malaysia which are driven towards a disclosure-based corporate regime. It is noted that this section is not intended to reinvent the corporate wheel in regards of the existing disclosure requirements. The discussion goes beyond the boundary of mandatory disclosure as required under the Companies Act 1965 and the Bursa Listing Requirements. This is because disclosure ought not to be confined to quarterly financial reporting and major Bursa announcement only. It is neither satisfactory to stop at step 2 and 3 (as shown in Illustration 5.4) if one wishes to achieve higher board disclosure and transparency. In the context of *Corprimacy*, the stepping stone acts as the link or bridge for the existing disclosure-based corporate regime to reach a new level of board disclosure for the purpose of better transparency. The stepping stone here is meant to be the enhanced disclosure best practices that shall form part of the corporate governance system in a corporation.

Under the Malaysian Bursa Listing Requirement, a board is required to give a statement in Bursa announcement as to their opinion that a particular transaction or dealing by a corporation is in the best interest of the corporations and its shareholders. There is no further explanation or justification required from directors as to how the board had exercised their business judgment in good faith for proper purpose in arriving at the opinion that the transaction or dealing is in the best interest of the corporation. This is a fundamental flaw in the disclosure practice. In adopting the *Corprimacy* approach, it is proposed that a board should be made to disclose to the Bursa and the public pertaining to the various factors that they have considered in justifying that a particular transaction is in the best interests of a corporation by going beyond mere statement of “best interest of the corporation and its shareholders”. It is viewed that such disclosure is vital in

ensuring the decision made by the board is acceptable in business sense to the corporation and its shareholders as a whole. This is because what is in the best interest of the corporation in the mind of the board might not be the same with the opinions of other relevant stakeholders.

In this regard, one may raise doubts as to the practicality of having such a disclosure where it would lead to never-ending decision-making process. The response to this will be that the requirement of disclosure of information is not intended to hinder a board from making their decisions. Rather, the rationale of such disclosure is in line with the objective of *Corprimacy* to transcend all legal boundaries in stepping into higher ethical decision and board accountability. It will indirectly incorporate a sense of ethical values in the board when deciding whether a particular transaction is in the best interest of the corporation. That is why *Corprimacy* sternly believes in having shareholders to act as a watchdog over a board for the purpose of ensuring check and balance in the corporate management.

Another proposed best practice covers the extent of interest which a director is bound to disclose. It should be extended and not limited to only related-party transaction and interested matters. In other words, a director is obliged to disclose any interest or connection that he may have or know of in a particular transaction. It is not sufficient that the director merely disclose certain information pertaining to his interest but it should also include any third party interest directly or indirectly related to him that may be at variance with the interest of the corporate entity as a result of the transaction. This is to ensure that directors exercise their best independent judgments while deciding whether a proposed transaction is in the best interest of the corporation. This enhanced

disclosure best practice is vital in protecting minority shareholders whilst leaving no room for directors to commit malpractices.

In term of better transparency, there should be full board disclosure to shareholders on the background of the nominees who hold shares on behalf of the directors concerned. Mushera (2001) also recognised the problem of “nominee holdings by hiding the true beneficial owner” in public-listed corporations. This problem is worsened in a family-concentrated corporation where the director who founded the corporation will usually hold substantial amount of shares through his nominee holdings. In other words, it will be hard for other shareholders and investors to understand the real picture of shareholdings a director has in a corporation by screening through the financial reports. This may lead to manipulation of share price by the director concerned via huge acquisition or disposal of his nominee shareholdings in the corporation if they withhold any sensitive information from the public.

The focus of this disclosure best practice in corporate governance system should be put on the basis of protecting minority shareholders. The objective of having constant full disclosure regarding the affairs and financial matters of a corporation is to educate shareholders so that they are kept updated with the latest information. With sufficient information, they may then easily form their decision based on the constructive data and figures in hands. Ho (2003) assumed that “if minority shareholders grow increasingly active and knowledgeable and become the ‘first line of defence’, more protection for minority shareholders will be put in place. For instance, disclosure requirements need investor vigilance to monitor actual practices, particularly in terms of related-party transaction disclosures”. One ought to remember that most of the minority shareholders are unsophisticated retail investors as compared with large institutional shareholders.

They may not have the necessary resources to be vigilant enough in monitoring the board practices. As a result, enhanced disclosure best practice shall be the stepping stone to complement the lack of resources and inadequate shareholder activism amongst minority shareholders.

Having greater level of disclosure and transparency, minority shareholders would have the opportunity to pull out their investment from a corporation if there is any untoward situation faced by the board. At the same time, shareholders will be well aware of any unfavourable transaction that a director intends to enter into, of which the director's interest conflicts with the best interest of the corporation in the short run. Such enhanced disclosure will help to ensure that minority shareholders are given sufficient notice to act rationally and swiftly.

### **5.5 Increased Integrity of Independent Directors**

Apart from the aforesaid disclosure best practices, integrity is always the main concern when it comes to corporate failure or collapse. The disclosure best practices hinge on the integrity of a director sitting in the board of a corporation. Even if there is implementation of disclosure best practices in the governance system of a corporation, it remains a failure if a director does not hold on to the highest level of truthfulness and uprightness. However, it is difficult to instil integrity in every single director since a board is usually composed of different mix of individuals from diverse backgrounds and characters. Hence, it will be wise to begin the discussion on integrity of independent directors who are supposed to be independent from a board. It is instructive to examine how an independent director can play their role and exercise independence with higher integrity and trust.



First of all, an independent director must possess the necessary skill, knowledge and experience to independently assess board's decision based on the intrinsic value of the subject matter discussed in a board meeting. In *Beam v. Stewart* (2004), the United State's Delaware Supreme Court reaffirmed that "the primary basis upon which a director's independence must be measured is whether the director's decision is based on the corporate merits of the subject before the board, rather than extraneous considerations or influences". Basically, there are two limbs which can be deduced from that case. The first limb requires directors to evaluate the corporate merits of the subject before a board. To do so, an independent director will need to have sufficient knowledge of the subject matter discussed in the boardroom. Thus, personal qualification and skill of a director will be called into question since he should exercise his independent judgment in making his own assessment and decision. It will be hard to imagine that minority shareholders will be properly protected by an independent director who is lack of experience and knowledge to detect any irregularity in a board.

With regard to the background and knowledge of an independent director, Barker (2009) augured well that higher quantity of independent directors in the boards of the United Kingdom and European banks proved to be inadequate in preventing financial crisis from happening in 2007/2008. It was explained that "unless allied with specialist knowledge and training - the technical independence of directors does not necessarily translate into the critical and independent thinking that uncovers fault lines in complex business strategies". Of course, it will be idealistic to have independent directors who are experts or specialist in their own field. However, when we touch on the issue of integrity, it does not necessarily mean that an independent director ought to have the highest qualification or specialisation to be appointed to the board. The technical duties

of examining the records or statements are best left to the internal and external auditors of a corporation.

Rather, it makes more practical sense when Barker (2009) argued that “the convening of a distinguished panel of men and women will be ineffectual if those directors do not also possess the expertise to understand the fundamentals of the company’s business and the attendant risks”. Due to the complicated intricacies in the modern business reality, independent directors must have the minimum qualification or working experience on business administration or financial matters or at least possess some basic knowledge on the business activity of a corporation that they are hired. This is simply because the reason of having one-third of independent directors in a board is to ensure that they can apply their independent mind without being largely influenced or dominantly controlled by other non-independent directors. Having the basic understanding of the policies and business of a corporation, an independent director is able to uncover any potential conflict of interests or risks that may give way to corporate malfeasance. This in turn contributes to greater integrity and independence of which an independent director is the guardian of minority shareholders interest.

In furtherance to the need of appropriate background and basic knowledge, an independent director should not be contented with his or her existing qualification and skill possessed. There shall be a constant quest for more relevant information regarding the business activities and financial affairs of a corporation even if they are merely independent non-executive directors of the corporation. With the required information and knowledge, an independent director will be better equipped with the skill of examining and accessing the veracity of information disclosed to the board by the

management team. On this note, Flannigan (2009) rightly re-evaluated how an independent director should act nowadays:

Independent directors are frequently identified as instruments of investment protection for passive capital. They ostensibly enhance the quality of corporate decisions and constrain opportunism. In many instances, however, independent directors serve active capital openly or tacitly, or they provide a supportive veneer of legitimacy while offering ineffectual oversight. Independence is often a façade or an illusion. It is compromised by levered or career-advancing deference, community of ideology, social fraternity, fear of marginalisation, managed information access and a variety of other significant behavioural incentives and limitations. These factors impel independent directors to ‘see’ the logic or utility of the proposals of controlling coalitions. They become tools, rather than filters, of the agendas of active capital.

Based on the above re-evaluation by Flannigan, it is definitely not an overstatement to say that independent directors are the guardian of capital for minority shareholders who are generally inactive in their investment approach. On the other hand, it is also not an understatement to agree that they often serve the interest of majority shareholders who control a corporation due to several internal and extraneous factors such as the enticement of monetary rewards, retaining of their board position and denial of access to certain information. This is the very reason why independent directors should break free from the chain used by controlling shareholders in order to find out the wrongdoings of other directors in a board. They should not accept whatever information fed by the board or management during meetings. But they should carefully sieve through the

information and critically scrutinise them in the presence of the board. If it is successfully done, then independence shall no longer be a facade but a reality.

Essentially, the integrity of director's independence centres on the axis of business judgment rule. In *Aronson v. Lewis* (1984)<sup>25</sup>, the United State's Delaware Supreme Court ruled that "the requirement of director independence inheres in the conception and rationale of the business judgment rule". It means that an independent director shall adhere to the standard of business judgment rule as required by the corporate law. The *Corprimacy* inheres that the business judgment rule should be exercised in the best interest of a corporation which includes the entire stakeholders. They are expected to introduce elements of objectivity and impartiality into board decisions due to their independent stand. Sadly, this is not the case in the real corporate life where independent directors are appointed in public-listed corporation for two plain reasons – to fulfil the one-third requirement under the Bursa Listing Requirements and to take advantage of their connection and social status for the purpose of securing projects and other marketing related duties.

Transmile scandal is a case on point. The unfortunate event happened in Transmile case would have somewhat been avoided had the independent directors exercised their business judgment rule in detecting the misleading financial statement. It certainly did not make commercial or financial sense that Transmile was making huge profits at an increasing rate when the corporation had just bought few airplanes which had not been geared into operation yet. Hence, the cash outflow of the corporation in the purchase costs of the airplanes should have been taken into consideration by the independent directors before approving the financial statements. On 28 October 2011, the Sessions

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<sup>25</sup>473 A.2d 805 (Del. 1984).

Court has delivered the first landmark decision where the two independent directors who sit in the audit committee of Transmile were sentenced to 1 year imprisonment for knowingly authorising the submission of misleading financial statement to Bursa Malaysia under Section 122B(b)(bb) of the Securities Industry Act 1983. The Star News (12 November, 2011) reported that:

... the judge emphasised that the audit committee has specific duties, functions and responsibilities and that the investing public rely on them very much. He said that in this case the evidence showed a blatant disregard of the seriousness of the concerns on the contra transactions when the committee was told by Deloitte (Transmile's auditors then) that the contra transactions were very unusual and lacked commercial justification. These, he said, were sufficient warning bells and as audit committee members, they should have raised these issues to the board but instead failed to do so.

The above decision sent a clear message across boardroom that good corporate governance requires cautious exercise of business judgment rule on the part of independent directors as their integrity will stand to protect minority shareholders as a whole. They should not act as “ornamental pieces” whose duties are restricted to attending board meetings regularly in order to rubber-stamp financial reports and other documents. As mentioned earlier, independent directors are expected to scrutinise corporate decisions and matters.

Generally, an independent director should not be under the dominance and control of any entity or individual directly or indirectly. That is the gist of director’s independence in accordance with Paragraph 1.01 of the Bursa Listing Requirements where an

independent director must not be an executive director or officer of the listed corporation. Further, the Listing Requirements prohibit major shareholders or nominees acting for the executive director or major shareholders from being appointed as the independent directors of the listed corporation. The underlying rationale of this rule is to minimise the dominance and control of executive directors and majority shareholders. In this context, minority shareholders will hardly be protected if the hands of an independent director are tied by the dominance and control of non-independent directors who are often the controlling or majority shareholders of a corporation. If an independent director is not truly independent in the practice, then it makes things easier for majority shareholders to expropriate wealth from minority shareholders by engaging in manipulative scheme or act that speculates the value of a corporation's share price.

An independent director is hardly independent when practically he or she is appointed by the board that comprises of controlling shareholders and management team. Bhagat and Black (1999) criticized the credibility of independent directors as “lapdogs rather than “watchdogs” over the affairs of corporations. Most often than not, an independent director will not be bold enough to challenge or question the decision of other directors who jointly appointed him onto the board. This is akin to a “lapdog” as what Bhagat and Black (1999) lamented on the integrity of an independent director. As such, it will be extremely odd to see that they will not rubber stamp the board decision when asked to do so by other non-independent executive directors who are also their appointers. In this regard, it is right to say that pure independence will only happen when fear or favour is totally eliminated or greatly reduced. At that point, they are no longer afraid of being removed from the board by controlling shareholders.

Nevertheless, mere presence of dominance and control upon an independent director does not always mean that the independent director is not independent in the absence of conflicting interests and personal benefits arising from a particular decision or transaction. It is worthy to note that the “relevant inquiry is not how the director got his position, but rather how he comports himself in that position” as viewed by the United States Delaware Court of Chancery in *Andreae v. Andreae* (1992)<sup>26</sup>. The real test of how an individual comports himself as an independent director in a board stands on the strong footing of integrity. The case of *Andreae v. Andreae* (1992) postulates the need to understand the importance of distinguishing one’s position as an independent director with one’s self awareness of duties and responsibilities towards the corporation as a whole.

For instance, in a recent takeover bid reported in the Star News (January 12, 2011), the independent directors of PLUS Expressways Bhd (PLUS) had taken a constructive approach of requiring bidders to pay an upfront deposit of RM50 million with the offeree company and to provide proof of funding “as a means to determine their seriousness and credibility” within a given deadline. On 12 January 2011, one of the bidders, Jelas Ulung Sdn Bhd failed to deposit the said amount of money to PLUS. In a way, this brilliant action has greatly eliminated uncertainties surrounding the takeover bid over the assets and liabilities of PLUS. The reduction of uncertainties will also help to ward off any unwanted share price speculation of PLUS. The aforesaid action taken by the independent directors is laudable in view of the proactiveness shown on their part. The independent directors had indeed exercised their business judgment rule in a way that uphold their integrity of independence without fear or favour to any internal or external party.

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<sup>26</sup> 1992 Del. Ch. LEXIS 44, \*14 (Del. Ch. Mar. 3, 1992).

Notwithstanding that an independent director may be truly independent from a board, it makes little difference to the level of protection of minority shareholders if there is no integrity on the part of the independent director. For example, even if the independent directors may have discovered the hanky-panky of the financial status of a corporation but they choose to be quiet instead and indirectly condone the action or decision of the other non-independent directors. For this reason alone, no level of independence could save a corporation if their integrity is overshadowed by greed and position. At the end of the day, it is the professionalism that an independent director should portray in upholding their integrity in managing a corporation. Independent directors must be able to garner the respect from their colleagues sitting in the same board so that their words are being heard and well accepted. They should not feel intimidated to question the board and voice out their concern. To be able to do so, it entails business acumen along with sufficient information in their hands. After all, their integrity lies on the legitimate expectation that they champion the interests of a corporation, in particular minority shareholders who are vulnerable to oppression by majority shareholders. Besides independence within the board itself, it is also important to gauge the appropriate level of board independence from the management in the context of *Corprimacy*.

## **5.6 Modernising Board Independence from the Management**

Strictly speaking, there is no law or rule in Malaysia that prescribe for board independence from management. Neither there is any law that can explain the sound level of independence a director or board should have in making a decision. This is mainly due to the difficulty to measure the degree of independence since it concerns the minds of directors. Although it is nigh impossible to quantify the extent of



independence, it is possible to put in place several best practices that a board should adopt in order to be truly independent from the management.

At times, the corporate sector may be confused with the concepts of “director independence” and “board independence”. Indeed, there are differences between the two concepts in the eyes of *Corprimacy*. To have modernised board independence, it is of utmost priority to first examine the thin line that separates the two concepts. Although both the concepts share some similarities in their attributes and integrity, director independence strikes on the distinctive independence of each individual director in a board as compared with board independence which requires a board to be independent from the external influence and control of management team. Director independence is more predominantly seen in the values of an independent director as they are supposed to be independent from other directors in a board based on the eligibility of their appointment. For this reason, it is very unlikely that non-independent directors are truly independent since most of them are also appointed as executive officers in corporations.

On the other hand, the characteristics of board independence was laid down in *Aronson v. Lewis* (1984) to mean that every director must be able to form their own business judgment even if they have to rely on their colleagues who are more qualified and expert in the subject matter discussed. In other words, board should be independent from the influence and control of the management apart from self-independence within the board. This means that directors’ independence is the subset of board independence in which the former is an internal factor while the latter is an external factor to the board.

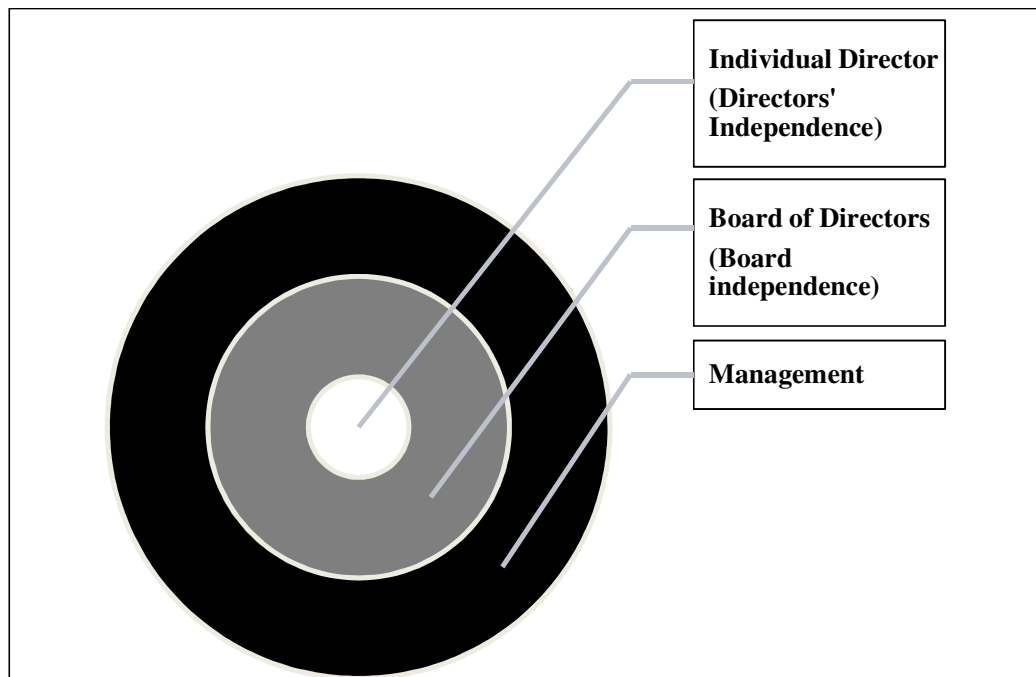


Illustration 5.5: Relationship between director, board and management in relation to board independence.

As we can see from the relationship between director, board and management as shown in Illustration 5.5 above, directors' independence originates from the core value of integrity and evolves into board independence from the management. In other words, independent directors may play an important role in board independence by providing independent assessment of board decision without any influence from the management.

As for the best practice of board independence, the Illustration 5.6 below shows the example of how a board deals with decisions involving governance and management issues in a corporation. Hansmann and Kraakman (2004) drew a fine demarcation of roles between a board and the management team where the latter should initiate and execute decisions whilst the former should monitor and ratify decisions. Beatty (2003) also shared the similar view on the distinctive roles of board and management. All these views constitute the key to the attainment of board independence from the management.

To further enlighten these views, governance decisions are usually made by a board concerning major transactions that a corporation intends to enter into with another party such as merger and acquisitions or disposal of assets and acquisition of properties. All these decisions will have a direct bearing on the interest of shareholders. On the other hand, financing decision will be mostly controlled by management who has full access to the financial information of a corporation. Hence, it is vital that a board should be totally independent from the influence or control of the management in their decision-making process.

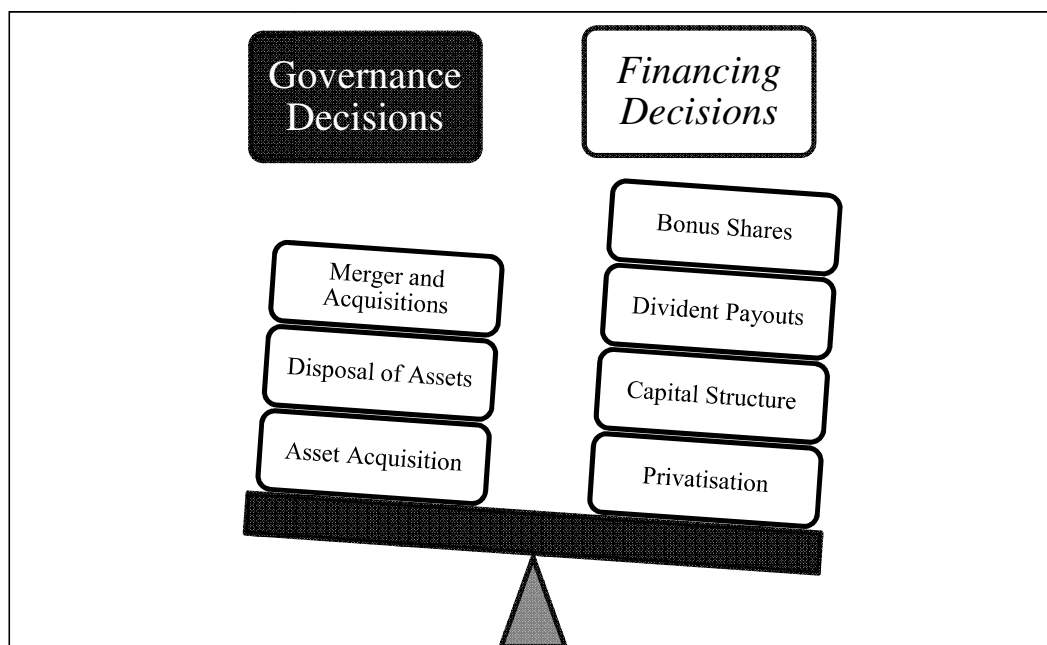


Illustration 5.6: Examples of balancing decisions between governance and management related matters by the board.

In terms of board independence, Green and Graham (2005) took a behavioural stance on the real sense of board independence when they argued that the literal meaning of independence refers to not seeking views or direction on taking action from others. Board independence will be modernised if directors move away from blanket reliance

on the management decision and the information disclosed to them. It was noted that directors rely on the management for information on important matters. But a board, as a whole, should be able to query that information in order to form their own independent opinion. Hence, it is not an issue whether a board should consist of more independent directors when it comes to board independence. What matters is whether a board can make decisions without undue influence from management.

In support of the behavioural aspect of board independence, Pahn (1998) discussed that there is little relationship between board structure and board independence since the boards must be prepared to fulfil their fiduciary duties without compromising their independence in making decisions. Dalley (2006) concurred that “a director who merely rubber-stamps the decision of management has failed in her duty of care because she has not exercised her own independent, informed judgment”. Board independence from management can only be attained with strict adherence of fiduciary duties by a director. Becht, Bolton and Roell (2005) criticised that boards often fail to be truly independent from management due to these two reasons – control of information by management as well as directors’ preference to “play a less confrontational ‘advisory’ role than a more critical monitoring role”.

On the other side of the same token, it may be argued by some scholars that it is hard to achieve board independence when CEO is inadvertently trapped between the policy decisions of the board from above and the policy implementation from below, by the top management team. This argument does not always hold water as CEO has wide managerial power that may influence board decision. As the leader of the management team, he will have ample discretionary power to carry out the implementation of board decision. As a result, board decision may not be turned into the desired board activity at

the implementation stage by the management team. Baysinger and Hoskisson (1990) agreed that “managers dominate their boards by using their de facto power to select and compensate directors and by exploiting personal ties with them”. In certain situation, CEO may manipulate the compensation arrangement devised for directors apart from dictating the final dividends to be issued to shareholders at large. CEO is able to manoeuvre his way up to the top with no problem at all. Such CEO’s power and control over a board will just get stronger in a situation of CEO duality where the CEO is also the managing director or the Chairman and director of a corporation. Nonetheless, CEO duality should not be a stumbling block for the implementation of board independence. In relation to this board structure, other directors in a board, especially independent directors must be organised to act in such unhealthy situation of board control by CEO. Board independence necessitates a board to set the tone from top to bottom rather than the opposite. To begin with, a Chairman could be the one who sets the right tone and precedent in a board since they often have the final say to reject or accept the proposal by management.

In the course of achieving board independence, directors should not breach their duties by merely relying on the management to deliver value to a corporation. It is the primary duty of a director to exercise their independent business judgment while dealing with the management. As discussed, an independent director should also play the role of watching over the board in controlling and supervising the actions of management. In modern terms, board should no longer be depending on the management who has been delegated with the decision-making power to manage a corporation. Greenfield (2007) opined that a “common challenge in corporate governance is how to utilize the distinctive capabilities of the management team most effectively without giving it so

much independence that it will ignore the concerns of those who contribute to the company's success".

In the local scene, the proposed acquisition of Garuda Energy ("Garuda") by Perisai Petroleum Technology Berhad ("Perisai") sparked off a recent case study on the significance of creating board independence that delivers value to the corporation. On 30 March 2011, The Business Times (30 March, 2011) reported that Perisai proposed to acquire Garuda from its former major shareholder and managing director, Nagendran Nadarajah for a sum of RM 210 million consisting of RM 150 million cash and 92.3 million new shares at 65 cent per unit. RHB Research (2011) commented that the proposed acquisition is questionable as it provides the avenue for the former controlling shareholder to re-enter the company via the proposed 92.3 million new shares amounting to 13.5% of the company's equity. Further, the share price of 65 cent per unit is at a discount of 20% from the closing price of RM 0.81 on the previous day. Another interesting issue is that Perisai sold Garuda to Nagendran Nadarajah in 2010 for a small amount of RM 15 million only as compared to the whopping offer price of RM 210 million. The deliberation of the aforesaid proposals shall be meticulously considered by the board based on independent due diligence report and business judgment rule for the benefit of the entire corporation including minority shareholders.

In a nutshell, it is hoped that the Perisai's case will not repeat the history of corporate collapse since the Transmile scandal was the classic example of how a board failed to be truly independent from the management. The misleading financial statement was prepared by the management for the approval of the board. To make matter worse, the board never questioned the veracity and accuracy of the statement in view of the fact that the managing director was also the CEO of the corporation. Naturally, he was the

ultimate decision maker with great dominance and control over the board. The interest of minority shareholders could have been protected if the best practice of board independence is effectively implemented. To substantiate this, the tipping point for the best practice of board independence is the active involvement by a board and shareholders in the corporate affairs and management-related issues.

### **5.7 More Active Board Involvement in Strategic Planning and other Management related matters**

Traditionally, boardroom is a meeting place where people with authority and control get together to approve matters concerning a corporation. It is usually the birthplace for board resolutions, policy-making and other decision-making related matters. In the modern time, evolution of corporate governance is at a fast-growing pace. Boardroom should no longer remain as what it used to be. It should be utilised as a room for heated intellectual discourse and robust strategic corporate planning. Regardless of the diverse backgrounds of directors in the boardroom, every director including non-executive director should take up part of the role as a professional manager who actively manages the business and affairs of a corporation whilst supervising the management team at the same time.

In this regard, Parker (1996) emphasised the importance of having appropriate strategic plans and objectives implemented within a corporation since “they can guide decision-making, improve corporate efficiency and effectiveness and provide the basis for longer term performance evaluation”. Noting the importance of effective implementation of corporate planning and strategy, it is high time that the board of directors should actively participate in the process of charting the course for corporate planning and

strategies, rather than merely rubber-stamping the proposed corporate plans submitted by the management. Ingley and Wu (2007) opined that “boards engaged in strategic thinking are closer to providing a strategic consulting service to the management team rather than simply monitoring a firm’s performance or its strategic behaviour”. Only with active involvement in the corporate planning and management related matters can directors fully understand the corporate policies in order to ensure proper implementation of the strategies. Furthermore, board will also be able to verify the accuracy of information and data supplied to them by the management team. Such active involvement will gradually transform into an effective monitoring mechanism that enhance corporate performance that can sustain shareholder value.

Nonetheless, some may persistently argue that directors may not have the time and energy required to run and oversee a corporation as these duties should be better entrusted to managers who are appointed to perform such job responsibilities. It is not necessary that a director should have spared ample time from their daily routines to actively participate in the strategic planning or management of a corporation. In other words, active participation or involvement in corporate management is still part and parcel of the fiduciary duties that a director owes to the corporation. In practice, a non-executive director or an independent director is not expected to actually take over the job of an executive or CEO in managing the daily affairs of the corporation. Be that as it may, they should be roped into the process of planning and drafting of corporate policies and strategies from time to time. This is to ensure that non-executive directors and independent directors are able to form better judgment when deciding on matters that they are fully aware of since they are well-equipped with the necessary information.



On the other hand, it was also argued that a board may not have the professional expertise to manage a corporation. The spill-over effect of active involvement by directors is that it may lead to excessive micromanagement of a corporation of which it is neither desirable to the directors nor the management. This argument does not hold water since the standard of business judgment rule as discussed earlier will come into play. Directors are not expected to exercise their utmost professional expertise to participate in the process of corporate planning and strategic management. Their active participation is significant in facilitating their monitoring and supervisory functions. As such, to better gauge the extent and level of board involvement, Millstein (1995) pointed out several factors that should be considered – board access to the same information as management, board capability to apply that information for better business judgment than the management as well as its implication upon corporate performance and other risk related issues.

Basically, the aforesaid factors necessitate the consideration of commitment and background of directors of a corporation. An informed decision-making process entails higher commitment from a board to discover more information and to undertake the responsibilities to digest the information before making any decision. In the case of *Paramount Communications, Inc. v. Time, Inc.* (1989)<sup>27</sup>, the United States Supreme Court agreed that “no one, after all, has access to more information concerning the corporation’s present and future condition [than managers]”. Hence, *Corprimacy* requires that directors shall endeavour their best to obtain as much information as possible from the management or other sources on a regular basis. It is no doubt that such process will definitely consume much time and effort on the part of the board. That is the reason why Millstein also put forward time and cost as the prime factors to be

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<sup>27</sup> 571 A.2d 1140, 1989 Del.Fed. Sec. L. Rep. (CCH) P94,938.

taken into consideration by board in order to ascertain the overall corporate performance as a result of board involvement in a specific governance matter.

In contrast, it is also common to see that most of the boards place heavy reliance on the management to feed them with all the necessary information and figures. In this context, Aiman (2009) addressed the reasonableness of director's reliance on information disclosed by the management as well as the corresponding duty of auditors in relation to financial reporting in which the reliance must be reasonable and directors must exercise "a modest level of scrutiny" rather than mere "unquestioning reliance". This duty of reasonable reliance corresponds with the best practice of board independence as discussed earlier. As such, we can see that the relationship between active involvements of board in management-related matters is closely intertwined with the very rudiment of board independence from management.

Legally speaking, the Companies Law Act 1965 also mandates directors to manage and direct the affair of a corporation. Once delegated, board must directly oversee the direction of the management in managing the corporation on their behalf. As Fama and Jensen (1983) classified a corporation's decision process into "decision management (initiation and implementation)" and "decision control (ratification and monitoring)", the former should rest on the shoulder of the officers to make decision regarding the daily affairs of a corporation whilst the latter should be the responsibility of directors to control the decision-making power delegated to the management. This is also to avoid any future dispute between the board and management as Salim and Lawton (2008) condemned that the court's "overly pro-management attitude" hinders the enforcement of directors' duties in overseeing the management. Hence, it continues that the best

practices of board independence and active involvement by board shall also be further substantiated by good corporate culture and strong board ethics.

## **5.8 Corporate Cultural Reform and Board Ethics**

This section seeks to discuss the various cultural norms that have long been embedded beneath the boardroom carpet and to propose some effective change to such conventional cultural norms in order to effectively implement good board ethics in a corporation. This is also necessary to strengthen the abovementioned best practices of corporate governance.

To begin with, an empirical study was conducted by Hirota, Miyajima and Katsuyuki (2007) on the corporate culture of Japanese corporations and it was found that “the strength of corporate culture significantly affects corporate policies such as employment policy, management structure, and financial structure”. The study also concluded that corporate culture is central to the understanding and formulation of the corporate policies which would lead to better corporate performance. Nonetheless, there shall be material change in the mindset of directors in order to effect any transformation in the corporate culture.

First and foremost, there shall be gradual board departure from the corporate cultural norms of complying with the majority rather than voicing out one’s constructive dissent and views. In this context, Sang-Woo Nam and Il Chong Nam (2004) commented on the modest corporate culture in Asian corporations where “independent directors may be far less independent in their behavior than those in Western countries”. This is where independent directors need to play their roles effectively within a board. To do so, they

may have to adapt to mindset change that challenge the decision or action by the other directors in a corporation.

While having internal board discussion, Sonnenfeld (2002) opined that “the highest performing companies have extremely contentious boards that regard dissent as an obligation and that treat no subject as undiscussable”. This is in accordance with *Corprimacy* notion that board should always seek to create and add value to the corporation. It is almost certain that value will not be created if a board is composed of many “Yes” directors rather than “No” directors. As business judgment rule is perceived as part of the duties of a director, there is nothing wrong for a board to encourage contentious arguments in board meetings. Such constructive arguments will certainly help to enable a fruitful discussion that bears effective solution at the end of the day.

In relation to this, boards should be easily acceptable to the idea of constructive discussion as part of good corporate cultural reform. Arguments should not be taken negatively as a challenge to each director sitting on the board. Rather, board arguments should be given credit as a “constructive conflicts” which produce different opinions and fresh perspectives from the directors. It is better to have more minds than just having one mind in generating positive results to corporate performance. Holloway and Rhyn (2005) rightly pointed out that “this would be better interpreted as ‘constructive’ conflicts, rather than just mere dissent, where the aim is to deliver more robust and effective decision outcomes”. They further proposed that “the roles of the chair and independent directors are central to guaranteeing that this robustness occurs by ensuring that both individual and collective voices/opinions are heard and valued”. Furthermore, it is appreciated that constructive conflicts are tolerable in terms of good corporate

governance as they bring about positive cultural changes to the boardroom. These changes are believed to have the effect of uplifting the level of board independence in making sound decisions that will eventually benefit the corporation as a whole. This is because a board should act and decide in concert as an entity regardless of any conflicting opinions amongst them.

Secondly, Holloway and Rhyn (2005) also argued for “more active involvement in the decision-making by employees through participative decision-making and enhanced levels of direct staff ownership in the organisation”. Such involvement would “entail ‘quantum’ changes in organisational values, culture, followership and prevailing senior executive top-down approach to decision-making. The leadership [then] becomes one of facilitation and support, not the current dominant ‘command and control’ mindset”. To do this, a board may even do the courtesy of inviting certain employees or staffs in a corporation to channel their concerns and opinions pertaining to a particular board action or decision. With such involvement in the board decision-making process, employees will feel personal attachment with the board as well as a sense of belonging to the corporation when performing their daily duties. Employees will also better understand the policies of the board as they take part in the decision-making process. As such, employees will find it easier to facilitate and support the execution of board decisions from the bottom level of the corporation.

Thirdly, another proposed cultural change is that of enforcing substance over form when it comes to implementing the best practices of corporate governance. In this regard, corporation may choose to perfectly complying with the corporate governance standards rather than the gist of corporate governance principles. It may be true that there is no evidence as to the correlation between corporate governance and corporate performance.

As a result, directors or management of a corporation feel complacent over their inaction regarding the actual implementation of corporate governance best practices due to the missing link of better result in corporate performance. Nevertheless, it is high time for directors to rethink their beliefs as the effective enforcement of corporate governance best practices will provide sufficient protective shields against sharp decline in corporate performance and create reasonable opportunity to avoid corporate failures as well. For example, Sloan (2002) addressed that the main cause of Enron collapse was due to the lack of “legal and moral responsibilities to produce honest books and records” on the part of the board.

Fourthly, cultural reform within a board will not be complete without the highest level of board ethics being put in place. In this regard, Aminah (2005) brilliantly illustrated the need of business ethics as the “glue” that push all individuals to do the right thing in order to achieve the “same vision and mission”. This will help to ensure that directors and management stick together in a good value system of governance ethics. Speaking of board ethics, trust and candor are two essential elements in pursuing good corporate ethical responsibilities. It is clear that no law can test the level of trustworthiness and honesty a director has. It is something related to the sense of ethical responsibilities deep down in the heart of directors. Nonetheless, it may still be instilled through strong cultural values of trust and candor as an exemplary board to the entire corporation and society. Sonnenfeld (2002) emphasised that it is important to have “a climate of trust and candor” as well as “a culture of open dissent” in order to create a critical and constructive board culture and social responsibilities. As can be seen from above, the corporate scandal in Enron is equivalent with the failure of board to act effectively. Board should portray good board leadership and ethics from the top. It is evident that the auditors in Enron failed to perform their duties in detecting the fraud committed by

the management. It is partly attributed to the board's breach of duties to oversee and direct the affairs of the corporation. Hence, board should supervise the management and filter whatever information and data produced by the management.

In a nutshell, all the aforementioned proposals, if implemented properly, will eventually lead to a healthy corporate culture that promotes strict adherence to board responsibilities and ethics. In turn, minority shareholders will reap the benefit from the creation and preservation of values in a corporation via drastic corporate cultural reform. In relation to this, Flanagan, Little and Watts (2005) proposed an alternative "professional" approach to governance which is more effective. Directors must act in a professional manner that upholds integrity and high board ethics in order to protect the interest of minority shareholders. The question of effective implementation will not arise if the aforementioned best practices are put in place in a corporation to encourage gradual transformation of corporate culture and board ethics. Nevertheless, it is correct to say that board ethics vary from corporations to corporations in view of different corporate structure and board composition. As such, it will be difficult to devise a set of board ethics that suit all corporations. Recognising the challenges faced in the self-regulation of board mindset, it is imperative to enhance shareholders' rights and powers in order to provide a mechanism of check and balance.

### **5.9 Enhancing the Shareholder's Rights and Powers**

Basically, the roles of shareholders must not be muddled with the significance of shareholder activism. An institutional shareholder may be actively participating in the general meeting or voicing dissatisfactions to the board of a corporation. Some shareholders may even raise persistent objection against the action or decision taken by

the board and management. The only missing link is that these shareholders are not empowered to effectively challenge such action or decision. In other words, most shareholders can be seen as toothless tigers with no claws to control and monitor the daily operation carried out by the management as well as the decision-making process in the boardroom. To make matter worse, the majority rule further prevents minority shareholders to act as an effective watchdog since often the majority shareholders will also have the final say on the direction and management of a corporation due to their substantial controlling stakes.

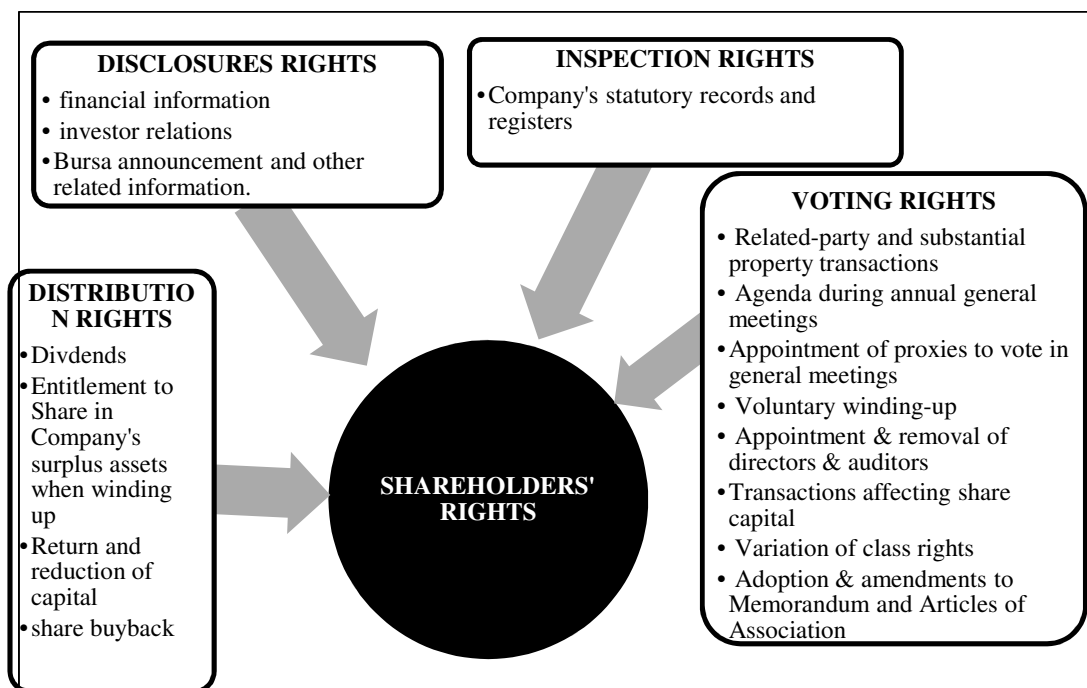


Illustration 5.7: Overview of shareholders' statutory rights

Despite the statutory rights granted to shareholders (as shown in Illustration 5.7 above), the majority rule outlines the need to enhance shareholders' rights and powers. In this context, it is advisable for the regulators to empower shareholders, especially minority ones to exercise more rights and powers in order to ensure that their concerns are addressed across the board table. Such empowerment is an important step towards a



higher accountability of the board as envisioned by the concept of *Corprimacy*. It is undeniable that the increasing roles of shareholders will create greater accountability on the part of boards and management where it provides alternative monitoring mechanism to stringent regulation and dry laws. Hence, this section seeks to critically examine the desirable rights and powers that a shareholder should have whilst proposing some mechanisms or practices that may enhance their rights and powers over corporation decisions and actions.

However, the effectiveness of granting shareholders right to control a corporation is uncertain in view of the power of controlling shareholders. Claessens and Fan (2003) argued that even if minority shareholders may have the equity interest in a corporation, it is still comparatively weak in preventing majority shareholders to take away minority rights. Based on empirical analysis, Listokin (2009) concluded that “increasing shareholder power without making other reforms to governance may not have an impact, but a failure to increase shareholder power may prevent the benefits of other corporate governance reforms, such as increased shareholder activism, from being realized”. With regard to the effectiveness of shareholders’ power, it is not a question of whether minority shareholders are able to speak against the stronger voice of controlling shareholders. The right question here is whether shareholder empowerment will improve the corporate governance system as well as facilitate the implementation of best practices.

Having said that, the code-based comply-or-explain concept in Malaysia does not and cannot exist in vacuum in the absence of the supplementary roles of shareholders in ensuring that directors do in reality adopt the principles of corporate governance and effectively implement the corporate governance best practices as embedded in the

Malaysian governance code. The empowerment of shareholders' rights and powers will become a major transition from the conventional "box-ticking" approach. At this juncture, it is not acceptable for boards to simply pick and choose to comply with any practices that the boards favour based on their whims and fancies. In refusing to comply with certain code-based principles or best practices, boards will have to face their shareholders to explain and convince them that it is in the best interest of the corporation to stick with such non-compliance. To do so, they would have to do more than mere explanation to the regulators and shareholders without any solid foundation or reasonable basis. Shareholders should understand that one of the red flags of corporate malfeasance may be attributed by the board's blatant reluctance or unjustifiable failure to comply with the Code requirements.

Moreover, the objectives of the regulators may be different from the ultimate goal of shareholders where the former desires of strict compliance with the rules and regulation while the latter aims to pursue wealth and to achieve better long-term value within a corporation that they invest in. Thence, the comply-or-explain concept should not be stretched by directors to the extent that they are able to flout the rules of the regulators as well as to ignore the goals of shareholders at the same time. With regard to effectiveness of comply-or-explain approach in the United Kingdom, the Korn/Ferry Institute (2007) carried out a study in 2007 via questionnaires completed by almost 800 directors from leading organizations in Asia Pacific, Europe and North America. The survey results found that 71 % of the surveyed participants agreed that the United Kingdom Combined Code of Conduct is an effective tool for corporate governance. However, only a simple majority of 51% of the surveyed participants agreed that the Combined Code requirements make their boards more cautious. On the same note, Montagnon (2008) opined that "shareholders cannot exercise their rights of ownership

unless a suitable framework allows them to do so”. He gave an example where shareholders may be helpful in promoting the independence of the internal audit process but they are helpless in devising and enforcing the audit requirements. It means that minority shareholders would not be able to play significant roles in ensuring the proper implementation of corporate governance best practices in the absence of clear code requirements. Gompers, Ishii and Metrick (2003) found that “firms with stronger shareholder rights had higher firm value, higher profits, higher sales growth, lower capital expenditures, and made fewer corporate acquisitions”. Certainly, it will be in the best interest of a corporation to enhance shareholders’ rights and powers by letting shareholders to have some say in the board decision-making process.

However, Dalley (2008) questioned the practicality of Bebchuk’s proposals to “let shareholders make business decisions”. It was argued that certain group of shareholders may abuse the power given to control the board via “persuasion, threats, and public exhortation”. Even in the context of shareholders’ voting right, Clark (1986) perceived the right as “a fraud or a mere ceremony designed to give a veneer of legitimacy to managerial power”. In support of this argument, Bainbridge (2008) also responded that shareholders’ voting right should be invoked sparingly as a last resort to hold the board accountable for their decisions and actions.

Recognising the potential abuse of such power in the encroachment of managerial power, it is timely to gauge the appropriate level of shareholder participation in governance related matters. In this context, Hill (1998) examined the relationship between the appropriate level of shareholder participation in corporate governance and the importance of shareholder interests within a corporate structure. She envisioned that there is a need for changes in the roles of shareholder since shareholders are able to

monitor and regulate managerial actions and decisions effectively. The effectiveness of shareholder consent in general meeting pertaining to related-party transactions was also questioned by Hill since “the extent to which shareholder consent provides a serious constraint on managerial decisions under the related party transactions is unclear”. It is true that shareholder approval on particular transactions entered by a corporation may serve as an important regulatory tool in the corporate governance mechanism of a corporation. However, it is believed that the power and role prescribed to shareholders under the Malaysian corporate law is not sufficient enough in view of increased complexity in modern corporate transactions and board decisions.

By empowering shareholders to monitor board and management, it does not necessarily mean that shareholders are given the direct responsibility of managing a corporation. It remains the duties of director to direct and manage a corporation. Hence, it is nothing close to what Manne (1967) anticipated that “if the principal economic function of the corporate form is to amass the funds of investors, qua investors, we should not anticipate their demanding or wanting a direct role in the management of the company”. In contrast, Aguilera (2005) identified the interrelationship between board, management and shareholders where “boards are the intermediary governance body between shareholders and management”. In *TW Services, Inc. v. SWT Acquisition Corp* (1989)<sup>28</sup>, the United States Court was of the same view that “while corporate democracy is a pertinent concept, a corporation is not a New England town meeting; directors, not shareholders, have responsibilities to manage the business and affairs of the corporation, subject however to a fiduciary obligation”. The remainder of this section discusses the issue of how shareholders, in particular minority shareholders, can ensure that directors

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<sup>28</sup> Delaware Journal of Corporate Law, Vol. 14, 1169.

are accountable for their actions and decisions by having more say in corporate strategic decisions and corporate governance related matters.

### **5.9.1 Shareholders to Have More Say in Corporate Strategic Decisions and Corporate Governance Related Matters**

Apart from increasing board involvement in the strategic planning of a corporation, minority shareholders should also be given more say in corporate strategic decisions and corporate governance related matters. The power of shareholders to have a say should not be understood as a stumbling stone to the development of a corporation in term of its business decisions. It should be considered as necessary safeguard for minority shareholders to monitor corporate actions and board decisions that are prejudicial to the interests of the corporation, in particular minority shareholders. The board will have no choice but to bear in mind the implication of a decision or action upon the long-term value of shareholders. Needless to say, shareholders' involvement in such a decision-making process would also mean that directors will be more cautious in making decisions so that their board's decisions do not contradict the best interests of a corporation as a whole.

Notwithstanding that, Blair and Stout (2006) commented that shareholders should have limited say in the corporate strategy and key decision since shareholders have elected directors to manage the corporation. Based on the separate function of each organ in a corporation, the argument is that directors should have the legal right to determine business strategy and to decide on other management related matters. Similarly, Bainbridge (2006) was not fond of the idea of active shareholder participation due to the reason that "under conditions of widely dispersed information and the need for speed in

decisions, authoritative control at the tactical level is essential for success”. It was said that active shareholder participation may interrupt the practical operation of a corporation. For instance, shareholders may perceive a contract as non-favourable to them while the board thinks otherwise in the best interest of the entire corporation. This may hamper the strategic direction of a corporation when shareholders start to disrupt the basic principle of separation of control and ownership. Whincop (2001) also opposed the idea of granting shareholders the powers to participate in the management decision-making process. He was of the view that shareholders may abuse the power to reap benefits for themselves in the absence of any fiduciary duty towards a corporation.

On the contrary, the more prevailing problem here is that of expropriation of minority interest by majority shareholders. This is where Shleifer and Vishny (1997) worried that “as ownership gets beyond a certain point, the large owners gain nearly full control and prefer to use firms to generate private benefits of control that are not shared by minority shareholders”. This lack of shared control is aggravated by the constraint faced by shareholders in exerting their rights and powers in a corporation. Scott (1999) highlighted the limited power of shareholders where they have inadequate information to monitor boards in public-listed corporations. As a result, it will be easier for a board and controlling shareholders to cover up any matter that are not beneficial to minority shareholders if they are being left out from the decision-making process. To resolve this conflict, Gomes and Novaes (2005) supported the notion of sharing control between controlling and minority shareholders in a given governance structure. As most of the directors are controlling shareholders, minority shareholders may benefit from this sharing of control rather than letting directors monitor the corporation on their behalf.

Gillan and Starks (1998) pointed out that if shareholders are not satisfied with board performance, they have three options: “sell their shares, that is, ‘vote with their feet’, hold their shares and voice their dissatisfaction, or hold their shares and do nothing”. Instead of threatening to exit a corporation via mass selling of shares, minority shareholders will have the last golden opportunity to put a stop-loss on the deterioration of the corporate performance or preventive measure on the mushrooming of corporate malfeasance. On this note, Zetzsche (2005) further categorized shareholder’s rights into two distinctive voices on decision and accountability. The voice on decision involves voice that “may yield a change in control” whereas the voice on accountability “facilitates shareholder monitoring”. In the United States case of *Unocal Corp. v. Mesa Petroleum Co* (1985)<sup>29</sup>, it was clear that “if the stockholders are displeased with the action of their elected representatives, the powers of corporate democracy are at their disposal to turn the board out”. However, this kind of voice on decision may hardly yield a change in control in Malaysian corporate environment which does not encourage the growth of shareholder activism. Rather, it is the voice on accountability that needs to be amplified in order to facilitate shareholder monitoring on board decisions and actions. To further enhance shareholders activism for the purpose of such voice on accountability, shareholders should also be allowed to have more solid determinative say on the corporate governance issues of a corporation.

Most often than not, directors will also try to restrict the questions from shareholders to the matters stated in the agenda of a meeting only unless there is any pressing arising matter. As a result, it will seriously hamper shareholders’ rights to hold the board accountable. Prior to any AGM, shareholders should be given the opportunity to submit to the corporation their proposals on various corporate governance issues so that such

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<sup>29</sup> (1985) 493 A.2d 946, 959.

issues can be discussed during the AGM. This is to say that shareholders are involved in the setting of the agenda for the AGM. By doing so, the board has little choice but to critically deliberate on shareholders' proposals before the AGM. Shareholders can reasonably expect better explanation by the board since they have sufficient time to prepare their explanation. In the event of dissatisfactory explanations, shareholders may appropriately exercise their right to demand for rectification on the part of directors or to hold the board accountable for their malpractices, if any.

In the United States, "shareholder proposals on corporate governance issues are typically submitted under Securities and Exchange Commission Rule 14a-8, which permits a shareholder to include a proposal and a 500-word supporting statement in the proxy statement distributed by a company for its annual shareholder meeting" (Black, 1998). Apart from merely inserting a corporate governance statement in the corporation's annual report, it will be in the best interest of the corporation to let shareholders to propose good governance best practices that may help to improvise the governance system of a corporation. If the proposed practices are deemed to be acceptable by the board, they may be included in the annual report as part of the governance system to be implemented in the coming year.

However, some commentators argued that shareholders will not have the appropriate understanding of the governance issues in a corporation since they are not actively involved in the daily management of the corporation. This could be counter-argued with the adoption of *Corprimacy* concept as every player in a corporation works as an important factor of the entire chain of production in the corporate governance system. Hence, by having more rights of participation in the affairs of a corporation, shareholders will have a better understanding of a corporation in order to form better



judgment on its corporate governance system and practices. They may not be actively involved in the management but they have an active role to play as the watchdog of the corporation.

Ostensibly, it may be argued that shareholders have been accorded many statutory rights to attend and vote at an AGM of the corporation they invested in. In fact, such participatory right does not seek to resolve the corporate governance issues of the corporation. Unlike the vigorous approach taken by shareholders in the United States, the Malaysian social culture normally does not really encourage shareholders to actively question the board during an AGM. Most of shareholders, especially individual investors prefer to be passive listeners rather than active inquirers in such general meetings. This may be partly due to their lack of knowledge to properly understand the information disseminated by the board. Some of these shareholders are speculative investors aiming for short-term quick return of investment. They are not really concerned much with the agenda of the meeting so long as they are satisfied with the reported corporate performance. Only positive figures of profit and high dividend yield that capture their attention most. Nonetheless, it does not rule out the corporate governance best practice that shareholders should have more say in such a meeting. On this note, Mcconville and Bagaric (2004) sternly argued that:

While it is important that the board and management have every opportunity to proceed with the business of making money for the company without being subjected to the corporate 'straightjacket' of shareholder harassment and disturbance, opening up the doors to shareholders only one day a year for coffee, cake and questions tips the corporate governance pendulum too far in the other direction.

Furthermore, there is very minimum discussion between board and shareholders in respect of a corporation's business plans and strategies due to constraint of meeting time as well as predetermined corporate strategies and decisions made by the board prior to an AGM. These problems in turn lead to the lack of effective communication between board and shareholders as shareholders' limited participatory rights only accrue in general meetings. To make matter worse, the attendance of shareholders at AGM is low and resolution still can be passed even without minority shareholders' presence. Scott (1999) concurred that "shareholder approval is likely to be a foregone formality in a public corporation". This is true in view of the lack of en bloc shareholders' voice due to the wide disperses of minority shareholders comprising of retail investors. Thus, it seems that after all, AGM should not be used as the only forum for shareholders to participate in the decision-making process of a corporation.

In relation to this, shareholders should be constantly consulted about the governance matters that shape the direction of a corporation as they arise. Bebchuk (2006) explained that "the choice is not between imperfect decision-making by shareholders and a mechanism generating perfect decisions". It is the close collaboration between board and shareholders as the members of a corporation that produces perfect decisions for the protection of minority shareholders. This is also the whole idea of adopting *Corprimacy* in the governance system of a corporation. In this regard, some may view that communication barrier is the main concern in considering constant communication between board and shareholders. Thus, in improving board communication with shareholders, Boros (2004) proposed electronic communication as a tool for constant engagement between board and shareholders. Hence, board engagement with shareholders will not be confined to corporate communication during AGM only.

Despite the fact that corporations are mandated to hold meetings with their shareholders, the Australian Parliament's Explanatory Memorandum to the Company Law Review Bill 1997 states that shareholders should have a reasonable opportunity to communicate with the board during the meeting. In Malaysia, Section 143 of the Companies Act 1965 provides that a general meeting of a corporation must be held annually. Having the right to attend meeting, the fact remains that shareholders do not have the say to influence or challenge the decision made by the board. Bowen CJ in the Australian case of *Re Compaction Systems Pty Ltd* [1976]<sup>30</sup> was of the view that "the right to advance arguments and to influence the course of discussion may in some circumstances have an effect, even a decisive effect, on the decision reached". As such, it is vital to put in place a corporate governance system in which shareholders may argue or challenge the board decision in an AGM.

By the same token, it is believed that stakeholders will also benefit from such active shareholder participation and shared control in the affairs of a corporation. This is due to the reason that stakeholders like employees, creditors and clients also wish to protect their interests by entrusting part of the responsibilities on shareholders. In this regard, Dent (2009) opined that shared control should be given to shareholders because they are the "primary residual claimants". Macey (1999) also put forward the similar point that "shareholders, as residual claimants, have the greatest incentive to maximize the value of the firm". These shareholders are highly motivated to enhance shareholders value while participating in corporate decision-making process.

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<sup>30</sup> [1976] 2 NSWLR 477, 485.

Summing up the importance of granting more say to shareholders, especially minority shareholders in the decision-making process, the White Paper on corporate governance in Asia, the OECD (2003) acknowledged that “shareholders must have some means of reconciling their differing interests, goals and investment horizons into basic strategic decisions”. Although shareholder activism is commendable, Romano (2001) conducted empirical research and found that such shareholder proposal has trivial outcome or insignificant impact on corporate performance. Notwithstanding this, Romano’s finding on the relationship between shareholder proposals and corporate performance does not discard the fact that it is in the best interest of a corporation and shareholders to sustain both values in the long run. In other words, shareholder activism facilitates the enhanced voice on accountability of which it may preserve the shareholder value by having more say on corporate strategies and governance-related matters. Evidently, corporate scandals like the Enron and Transmile could have been detected earlier if shareholders were given more say in governance related matters to keep a check and balance mechanism on the board.

### **5.9.2 Right to Actively Participate in the Board Nomination and Election Process**

Over and above the right to participate in the decision-making process of a corporation, shareholders should also have the right to actively participate in board nomination process. In normal circumstance, a nomination committee has the right to recommend to the Board, candidates for all directorships as well as memberships of all board committees of a corporation. Although the Companies Act 1965 allows shareholders to nominate their directors, this right is rarely exercised by them in practice. This is partly due to poor awareness of such nomination right. Even if they wish to nominate a

director, their effort will still be in vain as the approval of their recommendation depends on the ultimate decision of the board. Hence, it is even more obvious that minority shareholders should have the right to nominate their choice of directors to be elected into the board.

Based on the cost-benefit analysis, the result of having elected shareholder-nominated directors in comparison with the cost involved is not desirable. The United States Securities and Exchange Commission Task Force on Shareholder Proposals (2003) reported that “new mechanisms to increase on a routine basis shareholder participation in director selection will not be worth their costs because they will not likely result in significant numbers of shareholder-nominated directors being elected”. Therefore, feasible studies on a cost-efficient mechanism of shareholder participation in board nomination process should be carried out by the board who intends to adopt this best practice. It is not the quantity of shareholder-nominated directors or the cost of such nomination process that matters in terms of good corporate governance. It is the quality of improved board accountability that benefits a corporation as a whole. Comparatively, the overall benefit outweighs the cost incurred in the long run. Shareholder-nominated directors will have higher sense of accountability towards their shareholders who have nominated them. The benefit is most significant in the level of accountability when a board decides or acts.

In respect of enhancing the voice of shareholders on accountability, proxy access may be contemplated as one of the options to create a more democratic board that operates for the best interest of a corporation as a whole. In this context, Bebchuk (2003) agreed that directors who are selected by shareholders will benefit from the “reduced insulation” and “increased accountability”. The Council for Institutional Investors (2010) defined

proxy access rule as “a crucial mechanism that gives shareowners a meaningful voice in corporate board elections. It refers to the right of shareowners to place their nominees for director on the company's proxy card”. In the United States, the Securities and Exchange Commission (SEC) took the bold initiatives to amend the federal proxy access and other rules to facilitate the rights of shareholders to nominate directors to a company's board on 25 August 2010. Amongst others, the new rules state that (1) “shareholders who otherwise are provided the opportunity to nominate directors at a shareholder meeting under applicable state or foreign law would be able to have their nominees included in the company proxy materials sent to all shareholders” and (2) “shareholders also have the ability to use the shareholder proposal process to establish procedures for the inclusion of shareholder director nominations in company proxy materials” (SEC, 2010a).

In this regard, the Chairman of the SEC was also of the view that “as a matter of fairness and accountability, long-term significant shareholders should have a means of nominating candidates to the boards of the companies that they own” (Goldfarb, 2010). The SEC believed that “these rules will benefit shareholders by improving corporate suffrage, the disclosure provided in connection with corporate proxy solicitations, and communication between shareholders in the proxy process” (SEC, 2010b). These amendments speak of the core principle of *Corprimacy* where the corporate governance best practices are all about the act of balancing the board accountability and authority in the best interest of a corporation. If a director is found to be irresponsible or not performing over a period of time, then shareholders may vote to remove directors from the corporate board in order to make way for more qualified candidates to take over the directorship. Warner (2010) opined that “proxy access is being hailed as a game changer that significantly enhances shareholder rights and, in particular, is widely believed to

give institutional investors unprecedented power in board director elections”. There is an ardent need to have a proxy access rule in Malaysia that allows shareholders, especially minority shareholders to nominate their choice of directors to represent their interest in a corporation.

In moving towards a more transparent board composition, it is important to have a similar proxy disclosure rule which is implemented in the United States which compels corporations to reason out why each director is nominated based on their qualification and background. If the fact that going through the regulatory process of enacting the proxy disclosure rule is tedious, it is advisable to incorporate similar proxy disclosure procedure in the corporate governance best practices code. However, the efficacy of such proxy disclosure rules is questionable since “for many boards, the focus of this exercise was simply to engage legal experts in wordsmithing a re-nomination rationale for current directors, rather than addressing gaps in board composition itself” (Behan, 2010). It is believed that such gap in the board composition may be filled by the shareholder participation in board nomination process. Even if the proxy access or disclosure rule is not implemented in Malaysia for any reason, *Corprimacy* requires that shareholders should take part in board nomination process for the purpose of higher board transparency and accountability.

At the very least, shareholders should have the right to be consulted with regard to the selection of candidates for directorships by the nomination committee before the whole voting process takes place. Principally, nomination committee should conduct objective selection without any favouritism. However, it is very difficult to achieve such objectivity in the modern corporate practice. Hence, shareholders’ participation would inevitably improve the objectivity test in the nomination process. Having consultation

with shareholders in nomination process, it will not only benefit the overall corporate governance in terms of a balanced mix of directors in the board, it will also smoothen the process of nomination and appointment of directors since the selected candidates would have been screened and pre-approved by shareholders as a whole prior to the voting process. This new approach will certainly provide an opportunity for shareholders, especially minority shareholders, to have a say as to the candidates of their choice to represent them in the boardroom as well as to protect their interest in the long run. In other words, it will also indirectly grant shareholders the power to decide on the appropriate board structure of a corporation.

The foregoing discussion shows that shareholders should be given the right to nominate their own directors via a more cost effective channel prior to an AGM. Perhaps, shareholders may bear their own cost and expenses in nominating directors. Even if this best practice is not considered cost effective, other alternative options should be given due weight by a board. One of them will be that of consultation with shareholders on their choice of directors. A board may propose a slate of directors for the secondment by shareholders prior to the AGM. If shareholders oppose any one or more of the directors, then they may notify the nomination committee of the objection. The nomination committee will have the discretion of accepting or rejecting the objection. In the event of acceptance, the nomination committee should consider to re-nominate new director or better still, request for new nomination from shareholders themselves. In case of rejection, the nomination committee will have to explain their reason of rejection to shareholders in the AGM. The nomination ball will then roll into shareholders' court to nominate their choice of directors during the AGM and it is up to the votes by all shareholders present in the AGM. Such enhanced shareholder democracy is certainly



the pivotal to the notion of *Corprimacy* where every constituent in a corporation has a role to play.

Instead of granting shareholders right to nominate the directors, Sullivan and Cromwell (2003) proposed that a nominating committee should consist of all independent directors who have the required skill and knowledge to select better candidates. It was argued that they are more capable of sieving through the recommendations from the management and making selection of director nominees. Reasonably the nomination committee should have the upper hand to recommend candidates for directorships in a corporation due to their ability to assess the eligibility and qualification of a person based on the corporate values and needs. Be that as it may, a nomination committee comprises of independent directors who are not totally independent from the manipulation by executive directors and other substantial shareholders. All the members of a nomination committee could be independent, but it does not rule out the fact that they are only one-third of the directors who sit in the board. They may have the power to select and recommend candidates for directorships. Paradoxically, the board, as a whole, would have the ultimate majority casting votes to approve or disapprove the selection by the nomination committee.

Similarly, Bainbridge (2002) propounded that “even the election of directors (absent a proxy contest) is predetermined by the existing board nominating the next year’s board”. As such, it is unlikely to see an impartial selection based on pure performance and qualifications as the nomination committee will tailor their recommendation based on the preferences of the board instead. Furthermore, independence is not always the only panacea when it comes to conflict of interest within the board. To align conflicting interests in a corporation, Abdul Wahid (2005) believed that good governance is

achieved by letting the owners, i.e., shareholders of a corporation to elect directors who will then appoint and monitor the management team.

Even if this best practice of shareholder-nominated director is not adopted by the board, shareholders shall be given reasonable time and opportunity prior to the AGM to understand the reason why the nominated slate of directors should be appointed to the board. The board should also provide concrete explanation on how the nominated directors can help to create or deliver values to a corporation and thus, adding to the shareholder value. It is viewed that the election of directors does not stop at the voting rights of shareholders. Shareholder rights should advance into the realm of nomination process as well. As a result, directors will be more susceptible to shareholders' views in the meetings once they reckon the presence of shareholder power and pressure on the nomination and election process.

In short, there shall be corporate governance best practices of providing the right forum and opportunities to shareholders to actively participate in the board nomination and election process. Minority shareholders will be better protected since directors will fear of losing their positions due to increasing shareholder pressure and active monitoring. In completing such best practices, effort must also be carried out by a corporation and the regulators to revive shareholder activism for the aforesaid purposes.

### **5.9.3 Reviving Shareholder Activism**

In the realm of reviving shareholder activism, focus is thrown on the best practices of a corporation rather than the initiatives of regulators which have been briefly discussed in chapter 4. Despite the establishment of the MSWG, the shareholder activism is still

relatively weak in relation to the governance system of a corporation. Most of the boards are not keen to encourage shareholder activism for fear of interference in their daily affairs. Paradoxically, Henwood (1997) believed that shareholders nowadays “are far less passive, boards less rubber-stampish, and managements less autonomous than at any time since Berle and Means”. This does not paint the real picture in the modern corporate world as board and management creatively obtain shareholders’ approval during general meetings. One could not compare shareholder activism using the spectacles of Berle and Means with spectacles of 21<sup>st</sup> century. This is because boards have become more sophisticated and well-verse in management tactics that may fool shareholders in the end. Due to complicated financial terms and corporate matters, most shareholders choose to be passive as long as they are rewarded with dividends and bonuses. As such, it is very difficult for shareholders to be actively involved in corporate affairs in the absence of good governance mechanism.

With regard to the shareholder activism in the United States, Partnoy and Thomas (2007) were of the view that “after 25 years, institutional shareholder activism appears to have had relatively little impact on US corporate governance.” Karpoff (2001) also found that shareholder activism has little or no impact on the share price and earning of a corporation. In contrast, Smith (1996) found that “shareholder activism is largely successful in changing governance structure and, when successful, results in a statistically significant increase in shareholder wealth”. Regardless of the good or bad of shareholder activism, one may not deny the fact that shareholder activism is required to facilitate their participation in the corporate strategies, governance-related matters and board nomination process as discussed above. This chapter does not intend to repeat the discussion on how significant is the shareholder activism in corporate governance as it has been vividly evidenced in previous chapter.

Essentially, *Corprimacy* necessitates that board should seek to stimulate shareholder activism via improved communication and productive meetings. Davis (2003) illustrated underlying the right behind the shareholder activism is that of the general meeting where shareholders may drag the directors to the meeting table for explanation and discussion. Despite of the general meeting where shareholders and board only gather to meet once a year, there shall be a governance system where shareholders may regularly engage with the board on the affairs and activities of the corporation. It should not be seen as a hurdle against the board efficacy as such best practices provide a conduit pipe for the board to know their shareholders better and vice versa. The enhanced shareholder activism will provide a good check and balance on the board activity.

All in all, shareholder activism should be revitalised in order to facilitate the exercise of shareholders' rights and powers. In the absence of shareholder activism, rights and powers given to shareholders will remain as white elephants with no implication on board decision and action at all. This is clearly evident in the case of Transmile where shareholders have no means to discover that the financial information provided by the board was fraudulent in fact during the AGM. Without strong shareholder activism, it is likely to be a foregone formality of "rubber-stamping" the information fed by the board. Hence, shareholders activism is positively related to better corporate governance through enhancement of shareholders' rights and powers.

### **5.10 Best Practices of Executive Remuneration Policy**

As part of the reform on corporate governance best practices, it is high time to revisit the executive remuneration policy in order to ensure that there is no excessive remuneration which may jeopardise the financial standing of a corporation. Without adequate constraint and monitoring on the remuneration policy, Bebchuk and Fried (2004) identified several reasons that cause excessive remuneration package to the executives – management pressure, empathy to executives, lack of incentive to negotiate the remuneration and board failure in their oversight role. When board fails to perform their oversight role, it is necessary to improve the shareholder monitoring mechanism upon the remuneration policy of a corporation. Recognising the importance of reviving shareholder activism, this section discusses how shareholders can also play their roles in the governance system of a corporation in relation to remuneration policy.

It follows that excessive remuneration has induced heated debate amongst scholars and regulators on the reasonableness and appropriateness of the sum paid to the board and the management in foreign countries. Bebchuk (2005) argued that “without adequate constraints and incentives, management might divert resources through excessive pay, self-dealing, or other means”. For instance, excessive executive compensation at Fannie Mae in the United States was one of the major causes of its winding up during the recent financial crisis. The unreasonable executive remuneration policy in Fannie Mae was devised as a scam to cover up the huge amount of pay not connection to performance (Bebchuk & Fried, 2005). Notwithstanding shareholders’ right to approve an increase in directors’ remuneration during general meeting as provided under Para 7.24 of the Bursa Listing Requirements, it is still vague as to what amounts to directors’ remuneration. It is questionable whether the word “remuneration” includes fees, bonus

payments, commissions, shares allotment and/or dividends since the law does not provide any clear definition of “remuneration”. Even if shareholders may have the right to vote on any increase of directors’ remunerations, the next question that should be asked is whether there is any right to vote on the pre-determined amount of directors’ remuneration. In practice, it is very rare to have a shareholder proposing or deciding on the remuneration policies of a corporation as the corporation is in a better position to decide based on the corporation’s internal financial status.

First of all, it is a good corporate governance practice that remuneration committee should spell out the executive compensation policies and packages in details. Gordon (2006) proposed that “the compensation committee (or the independent directors that have taken on that role for companies without a compensation committee) should prepare and include in the proxy statement their compensation discussion and analysis.” Looking at the local scenario, the Malaysian Code provides that “the company’s annual report should contain details of the remuneration of each director”. However, most of the company’s annual reports in Malaysia do not stipulate the detailed remuneration of each director. For example, according to the Sime Darby Berhad’s Annual Report 2009, the remuneration of directors was categorized into executive and non-executive directors without specific amount of remuneration of individual director. Furthermore, there was no breakdown of the remuneration paid to the directors – bonus payment, salary, allowance or other compensation amount. As such, it is difficult for shareholders to gauge the reasonableness of the remuneration amounts and packages based on the total annual net profit of the corporation during the AGM. It defeats the purpose of seeking shareholders’ approval in the first place as it seems to be a “rubber-stamping” event in the AGM.

Similarly, Ho (2003) also pointed out the reluctance of the Hong Kong's corporation in disclosing their corporate policies on executive compensations due to the reason of privacy. Due to such non-transparency, the Hong Kong's regulator implemented measures to increase the disclosure of the details on the directors' remuneration to include the "aggregate amount, analysis by components, analysis by bands, remuneration policy, fixed versus discretionary pay, the value of options realized, and amount by individual name". At the very minimum, the Malaysian regulator should amend the Code to include the aforesaid details of analysis and information on the board remuneration. This is to ensure that the remuneration committee and the board are accountable for their decision of pay to the executives by taking into consideration the best interest of a corporation.

By adopting the best practice of disclosure, it will certainly boost the confidence of shareholders who witness higher board transparency. Moreover, shareholders and other stakeholders like creditors may form better judgment as to how their capital and loans are utilised by the directors. In the restructuring of remuneration policy, a corporation should also devise some models of executive compensation based on reasonable quantitative and qualitative criteria that benefit the corporation in the long run. It has been argued that there must be transparency and reasonableness as to the amounts of executive pay (Ho, 2003). This is simply because excessive executive remuneration may eventually culminate in additional costs to shareholders, especially its prejudicial impact on minority shareholders.

To enhance shareholder monitoring on the board, it is also proposed that there should be "say on pay" where shareholders are given the right to vote on the remuneration policy and package of a corporation. In this regard, McClatchy (2009) mentioned that a

corporation will detail out the executive remuneration policy in its annual proxy statement and it is opened for shareholders to put their non-binding vote on the said policy. It means that shareholders will not have the final say on the remuneration policy but a mere indirect advisory vote to increase or to decrease the amount of remuneration. Having the same rhythm with the notion of *Corprimacy*, shareholders who are more sophisticated investors may challenge the board and demand for justification on the determined pay.

Apart from detailed disclosure of board remuneration and shareholders' "say on pay", it is a best practice that "share retention policy" should be gradually introduced in the local corporate scene. In other words, such remuneration policy should be structured based on long-term performance-based reward approach as it will eventually benefit a corporation. In order to retain top performers in corporations as well as to recruit more new young talents, it is important to create a sense of belonging in the corporations where they are currently or are going to be employed. It may be created via employees' participation in the share option scheme of the corporations over a period of few years. The President and Chief Investment Officer of Fifth Third Asset Management, Keith Wirtz supported such reform of compensation arrangement by saying that "employees will have more certainty about their compensations because their bases are going up and it will be less tied to productivity" (Reuters, 2009). The comfort of certainty amongst employees will certainly create a sense of belonging since every stakeholder will have the opportunity to participate in the equity performance of the corporation. As such, this sense of belonging will slowly translate into a sense of corporate ownership.

Distinctively, such best practice of "share retention policy" is different from the conventional pay-for-performance policy adopted by most of the corporations in



remunerating their employees who have performed well in the year of assessment. This kind of pay-for-performance policy is no stranger to many corporations as one of the ways to retain top performers from resigning or leaving the corporations. The modes of remuneration may be that of cash bonus payment, stock options or increase in salaries. Most often than not, this remuneration policy will only generate short-term results as it does not guarantee the long-term success of a corporation. It is likely that there will be an unease atmosphere created in the workplace due to dissatisfaction by some employees who do not receive good bonuses. Some of these employees may even leave the corporation since they do not feel appreciated by their bosses.

In relation to the conventional pay-for-performance policy, some commentators debated that executive compensation based on stock options may have adverse impact on the share price of a corporation. To illustrate this, Dionne (2003) lambasted the Enron case where “several members of the board were privy to information about Enron’s management practices—overcompensation of certain executives and board members and disclosure of false statistics on the firm’s growth potential to increase the value of shares and options—but chose to ignore this information or not to transmit it to shareholders”. For instance, the CEO of a corporation is rewarded with stock options worth millions in value. Such stock options create a huge gap in view of the CEO’s annual salary of few hundred thousand. This will prompt the top management team to push the value of shares through distorting means. Share price may be manipulated by tampering with the financial reports of a corporation. As such, dishonest managerial behavior is positively correlated with executive compensation in terms of stock options. Notwithstanding the likelihood of such misbehaviour, the nature and structure of “share retention policies” is distinguishable from the mere reward of stock options. The dividing line lies in the method of rewarding stock option throughout a certain period.

In other words, reward of stock options is usually given to the executives in full sum on an annual basis whereas shares are given in parts to the executives over a span of few years in the proposed “share retention policies”.

In this regard, Lee (2003) agreed that “share retention policies” should be implemented by a corporation to mandate their employees to retain half of the shares granted. In 2009, it was reported that the gigantic Swiss bank, Credit Suisse changed its executive compensation structure by increasing the base salary of its executives at top managerial and board level. Part of the bonuses will also be deferred to a later date depending on the business performance and share price. In other words, the deferred bonuses which are in the forms of cash and stocks will be granted to the executives over a span of few years and will be restructured every year according to its business performance and equity (Hane, 2009). In the long run, minority shareholders may be better off as the corporate executives are naturally motivated to preserve the shareholder value when they are tied to the share retention benefits themselves.

Another cause of excessive executive remuneration is that of undue management pressure on a board and remuneration committee. In this regard, Jensen and Murphy (2004) noted that remuneration committee rarely challenge the proposed executive remuneration packages by the management due to lack of time and resources. Such management’s indirect control disrupts the corporate governance system of a corporation as there is no separation of roles and responsibilities between the remuneration committee and the management. To make matter worse, most of the members of the committee are controlling directors who are holding the top management posts in the corporation. Hence, there shall be some best practices that can minimise management pressure on the remuneration policy of the management,

especially the CEO. Zinkin (2010) viewed that the remuneration policy of a CEO should be set to reinforce the values of the corporation. However, the measurement of values in a corporation is very subjective as there is no single set of ethical values that may justify the amount of income received by the CEO.

On this note, Booth (2005) observed that a CEO has the ultimate control over board decision as most of the directors are selected by the CEO. The fact remains that “if you pay a CEO like a bureaucrat, he will act like a bureaucrat” (Jensen & Murphy, 1990). This reasons out that if the board is under the pressure to handsomely reward the management, they will surely be subordinate to the management who will dictate their directions upon the corporation. Be that as it may, it should be the board responsibility to determine the executive compensation as they owe fiduciary duty to shareholders. The board should move away from the claws of CEO in meddling with their duties of directing the management of a corporation. Furthermore, Reinhardt (2009) reviewed that board should stand to protect the interest of shareholders in having arms-length bargain with management over the executive remuneration policies. It was said that board should exercise their business judgment to decide on the executive remuneration packages. This goes back to the earlier discussion on the best practice of board independence from the management.

To minimise management pressure, the remuneration committee should act as the first defence line against such unwanted influence and control from the management. In other words, remuneration committee should consist of all independent non-executive directors and shareholder representatives. Klein (2006) empirically found that “a CEO sitting on its board compensation committee has both the motivation and the access to manipulate earnings to maximize his overall compensation package”. Hence, a CEO

who is also the executive director of a corporation should not be allowed to sit in the committee as well. This is to avoid any unwanted manipulation of executive compensation scheme that favours the CEO and his team. Instead of being pressured by the board and management, the composition of the remuneration committee should allow representation by shareholders. The rationale behind this proposal is that of board accountability to their shareholders so that they do not bow down to the management pressure that controls their position and remuneration. Likewise, remuneration committee will naturally be inclined to rewarding themselves handsomely if the decision-making power lies in their own hands as directors of a corporation. Although they may be named as the independent directors, this is a mere facade of independence in reality. It is a fallacy to claim that as independent directors will exercise their independent judgment in the best interest of a corporation when there is conflict of interests with respect to the determination of their personal remuneration. As such, shareholder representation in the remuneration committee will eventually push directors to uphold their integrity and accountability to the corporation as a whole. It will create an impression in the mind of a board that shareholders are their paymaster.

In conclusion, the best practices of remuneration policy should speak of board disclosure, transparency, shareholders' say, sustainable long term value of a corporation as well as total independence from the management pressure. However, minority shareholders interest will still be at stake if a corporation is lack of proper internal control and risk management. Thence, the next section continues to discuss on the importance of sound internal control and best practices of good risk management and audit process.

### **5.11 Internal Control – Risk Management and Audit Process**

In essence, a corporation that has sound internal control system may be able to preserve shareholder value and protect minority interest via good risk management and auditing process. This section does not intend to reinvent the wheel by discussing the mounting benefits of risk management and the auditing process but rather seek to propose governance best practices in a corporation's internal control system. The significance is also reflected in Section 167A of the Companies Act 1965 which requires a public-listed corporation to establish an internal control system to provide a reasonable assurance that the corporate assets are properly protected against any unauthorized disposition or loss.

Basically, a sound internal control system is largely depending on the effective implementation of strong risk management and proper auditing process in a corporation. Spira and Page (2003) observed that risk management is closely intertwined with the internal control system of which the degree of its management is a form of accountability in a corporate governance framework. However, it is difficult to spell out the appropriate degree of risk management in a corporation. This is simply because different corporation will have different level of risks involved in its business activities and corporate structure. As such, board accountability rests on the effectiveness of the mechanisms of monitoring and managing the exponential risks faced by a corporation. Good risk assessment and management will eventually lead to good internal control system. Another important engine of internal control system is that of sound auditing process. The following sub-sections will unravel how these best practices of risk

management and auditing process may be enhanced in order to protect minority shareholders. Firstly, there shall be a proper integration of risk intelligence governance. Secondly, a Chief Risk Officer shall be appointed to oversee the risk exposure of a corporation. Lastly, an independent audit process should be put in place to facilitate better internal control within a corporation.

#### **5.11.1 Integration of Risk Intelligence Governance**

Any risk element is vital in the pursuit of creative business solution, innovative products, competitive business edge and maximising shareholder wealth. Although vigorous risk-taking by a corporation is indisputable, but a calculated risk-taking is what a board should undertake to have a risk intelligent corporation. The best practice of risk intelligence governance fosters the corporate strength, resources and business acumen required to cope with the any contingency faced by the corporation. In this regard, risk intelligent governance is all about preserving shareholder value and creating more shareholder value at the same time.

Essentially, there are various risk intelligent mechanisms and measures that a board should integrate with the central governance system of a corporation. A board should adopt a well-designed risk intelligent action plan and best practices that sound as follows:

- a) Define the scope and level of different existing and potential risks posed to the corporation. A board should set the right tone for the appropriate level of corporation's risk appetite at the outset. This common definition of risk is applicable to all departments supporting the corporation. Hence, the board's

policies must not cause a corporation to engage in risk-taking activities that exceed the acceptable risk level. The management and officers of the corporation may discharge their risk responsibilities in line with the risk management best practices of the corporation.

- b) Set a strong tone at the top for independence, professionalism and ethical culture as an example to the auditors and the management in their efforts towards fraud prevention and reporting system. A board should take the lead to direct the management and the auditors in implementing such preventive measures in their risk management planning process.
- c) Craft a crisis management plan by taking into account of the risks the company faces whilst weighing their consequential effects upon a corporation in the short run and the long run. Risk intelligence governance also entails the need to have a crisis response and management plan in event that the risk materialised to create adverse impact upon the corporation. A well-thought crisis management plan can literally protect the interest of shareholders at the brink of financial crisis or business catastrophes. Perhaps, lessons should be learnt from the recent oil spill disaster at BP which is one of the largest oil conglomerates in the world. It is interesting to note that there was no crisis response plan at BP of which BP could immediately react to prevent and manage the oil spill disaster. It took the board at BP so long to create and implement their crisis response plan. Their plan which was divided into three phases, amongst others, includes the initial phase of disposal of assets worth USD10 billion to provide sufficient resources, the revision of safety measures to prevent future oil spill and the final phase of CEO replacement due to public scrutiny and government pressure. The delay in

executing an effective risk management plan had caused multi-millions losses to their shareholders which in turn diminished their shareholder value.

- d) Evaluate the risk performance and risk governance structure between the board and the committees. This is to gauge the effectiveness of risk management framework in relation to the corporate performance. Should the framework fail to improve corporate performance or minimise risk exposure, the board may engage the assistance of independent auditors or external party to reassess whether their risk-intelligent approach is responsive and workable to the risk impact. If need be, the risk governance structure should be revamped to enhance the scope of the board's risk oversight role.
- e) Hold frequent meetings or robust dialogues with the responsible risk officers and committees to further comprehend the underlying risks in relation to the business activities and management of the corporation. The board should not be contented with the risk assessment report presented by the committee or management. The board may challenge the management or committees or propose some new risk measures while probing into the risk report.
- f) Chart a plan for close collaboration and coordination amongst all the departments within a corporation via a risk intelligence sharing system. It is noted that some actions taken by the officers in one department may create a domino effect upon the other departments of the corporation. For instance, the sales department decided to discontinue a sales transaction with another party without prior consultation or sharing of such decision to the legal department.



As a result, the corporation is made vulnerable to floodgates of claims and legal suits by the party concerned.

- g) Designate the risk management committee as the central control of risk intelligence and management. All information should be kept properly in record and relayed to the board at monthly risk reporting meeting. The board and the management would have the aptitude to access the risk exposure of a corporation and swiftly response to them when needed. Inevitably, such information gathering mechanism acts as the main brainpower of directors who are the minds and intelligence of the corporation.
- h) Educate the officers and staffs in the corporation. All employees should be trained to understand the risks exposure and how to cope with such risks as well as what amounts to fraud and how to effectively report any suspicious fraudulent acts from bottom to the top.
- i) Restructure the composition of the risk management committee which is usually consists of directors rather than other officers in the corporation. Directors may not have the required resources and time to handle every piece of information in relation to risk management plans and processes. Hence, it is proposed that the risk management committee should also consist of key executives of the corporation like the CEO, the Chief Financial Officer, the Chief Operating Officer, the Head of each department, the auditors and other top personnel. Having these officers, the risk management committee will be able to decide and take action in response to any imminent risk or emergency situation.

- j) Review the risk management policies and strategies regularly and benchmark the policies with the latest development in other countries. Any risk management plan is a continuing developmental process. It is not an end itself but a means to the ends of protecting the best interest of the corporation. The board should take recognisance of the evolvement of corporate strategies and policies as well as the changing climate of the business and financial status in the corporation. Such ever-changing corporate environment would bring about never-ending antecedent risks to the corporation.
- k) Design a proper guideline or manual on effective risk monitoring and management for the reference of the corporation. Such guideline must be tailored corporate and business strategies according to the short term, medium term and long term risk exposure. Having a comprehensive manual, the management may carry out their duties according to standard operating procedures and indication of risks laid down in the guidelines.
- l) Shoulder the responsibilities of risk oversight as part of their fiduciary duties to the corporation. The conventional practice of leaving risk oversight responsibilities to the risk management or audit committee should be changed. Normally, the board prefers to leave the job of risk management to their designated risk department or the risk management committee. Although some corporations in the banking and insurance industries do have a department or division to oversee risk management, the board should not be relieved of their responsibilities in risk management. Rather, the board should exercise their overall risk oversight role in relation to monitoring and supervising the risk

management functions carried out by the relevant departments or board committee.

m) Review the financial standing of a corporation regularly to determine whether there is any financial over-leveraging or over-gearing problems such as excessive borrowings from creditors in comparison with the corporation's assets and capacities to pay back the borrowings. This is to avoid the potential risks of winding-up proceedings being initiated by the creditors for failure to repay the debts. An effective reporting system should be implemented by the board so that they may be alerted of any sign of over-leveraging. Even if the board decides to proceed with excessive borrowings due to the nature of their business, it is their duty to ensure that such risk exposure of over-leveraging is properly assessed and well managed. For instance, most corporations that involve in the construction industry would require huge capital layout in the initial phase of their projects since the usual practice of payment is made progressively based on the stages of completion.

n) Implement an internal anti-fraud control and reporting system. This internal system must be able to detect fraud when there is smell of "smoke" in the corporation. The "smoke" meant here is that of the fraud risk. The internal audit function of a corporation should facilitate the effective enforcement of such a system. A good starting point will be from the establishment of a whistle-blowing framework for every employee to identify any indication of fraud amongst the staffs and report it to the board. There shall be no exception to the top management team. The identity of any whistleblower must be protected with utmost confidentiality by the board. The board may clandestinely devise an

incentive scheme to reward the particular whistleblower from a specific fund allocated for such whistle-blowing action.

- o) Appoint an independent compliance officer to act as a whistleblower for the external fraud reporting system. His main duties will be to examine the records and to scrutinise the actions of the board and the management on a regular basis. This compliance officer must be independent from the authority and control of the board and management. To be truly independent, this compliance officer should be selected from a pool of qualified and independent compliance officers gathered by the regulators. As such, they are under the duties to identify any wrongdoing or fraudulent activity and to report it to the relevant authority or agency. For instance, if there is any non-compliance with the securities laws, the appropriate authority will be the Securities Commission Malaysia. Such compliance function is different from the internal audit function in a corporation. The compliance officer looks at actions and activities beyond the mere reported financial figures and data on papers. This fraud reporting system is closely intertwined with the whistle-blowing provisions under the new Whistleblower Protection Act 2010.
  
- p) The use of information technology that may support and facilitate the communication from top to bottom and vice versa. For instance, an information technology system may be created to enhance the financial or fraud reporting mechanism without exposing the true identity of the whistleblower.

- q) Appoint a Chief Risk Management Officer from the board to undertake the risk oversight role. There is more discussion about this in the following sub-section 5.11.2.

Having said, the aforesaid action plan is not exhaustive in nature. It requires the board to adapt the plan based on the need of their business and the nature of their corporation. The said plan should not be implemented in “silo” since it should facilitate other governance best practices. It is reiterated here that a board who fails to plan is planning to fail.

#### **5.11.2 Chief Risk Management Officer**

Strictly speaking, a corporation may have the best risk management mechanisms and control in their governance system. However, it is pointless to have the best system without an effective monitoring mechanism to implement such risk management practices. Essentially, risk management best practices depend on how fast a monitoring mechanism or body detects any mishap or error in the governance system of a corporation (Douglas, 1986). The focus of monitoring should be put on any red flags arising from those untoward incidents that happened in a corporation. The identified red flags should sufficiently draw the board’s attention to the questions of board responsibility and corporate performance so that the appropriate actions may be taken.

Notably, most of the public corporations in Malaysia do not have any officer to be in charge of the risk management of the corporation. Unlike other financial institutions, the responsibility of risk management is usually left at the shoulders of the internal auditors and the audit committee. These corporations often lose sight of the fact that

internal auditors or the audit committee will only focus on the corporation's financial risks during financial reporting process. It is equally important that the board should aware or be informed of other kinds of risk associated with the business activities and corporate actions of the corporation. In the absence of clear mechanism put in place for risk monitoring, such risks will not be easily identified by the board or management. Even if some of the post-financial disclosures risks may be recognised by the board, it would not enable the board to adopt effective measures to minimise the risks. This is due to the reason that the identified risks would have impacted the corporations to a certain extent. The real test lies in how fast the board or management can response to the risk exposed as well as how they can deal with the said risk diligently.

Notwithstanding that some corporations may have their own risk management department or risk officers, these officers are not appointed from the board of directors. In practice, such risk management department is only tasked to collect and compile risk reports from all departments in a corporation. Most often than not, their duties are to directly report to the Chief Executive Officer or to the board indirectly in relation to the risks posed by the information gathered from these departments. As a result, communication of any risks arose within a corporation will have to pass through few layers before reaching the board for their appropriate actions and decisions. To better manage risks, it is highly recommended that a Chief Risk Officer is appointed from among directors for the purpose of enhancing board accountability. The job function of a Chief Risk Officer is mainly to identify and access any risk accrued to the company's operations including tabling risk assessment reports to the board on a timely basis.

Having a Chief Risk officer, the board could ensure that their corporate plans and strategies are regularly assessed and reviewed in relation to any potential risks. From

time to time, the implementation of business activities and corporate actions are also closely monitored by the Chief Risk Officer who will in turn report them to the board. Depending on the level of the risk exposed, the Chief Risk Officer may promptly decide to take actions or measures to contain and reduce the risks without going through the board. This is because delay in managing risk may bring disastrous effects upon the corporation as time is of essence in risk management.

Furthermore, the Chief Risk Officer will better understand the risk appetite of a corporation as he or she is also one of the directors on the board. As part of the decision makers, the Chief Risk Officer will be able to propose appropriate controlling and preventive measures to the board based on the risk appetite and direction of the corporation. With effective risk monitoring mechanism, the board will have early opportunity to assess their corporate strategies and if necessary, to tailor their strategies in accordance with the risk level of the corporation. Perhaps, time may also be allocated for due deliberation and approvals on risk-related matters during board meetings.

For instance, the local insurance industry in Malaysia is also starting to acknowledge the importance of having a risk officer on the board to assure effective risk management of an insurance corporation. The President and Chief Executive Officer of ING Insurance Bhd, Datuk Dr Nirmala Menon strongly supports the idea of appointing a head of risk to manage the risk exposure of an insurer. She reasoned that “the board would be able to clearly understand a company's risks and accept any deviations from the risk strategy and appetite that have been set as well as form the second line of defence for the company”. The CEO of Prudential Assurance Malaysia Bhd, Charlie E Oropeza also viewed that “boards and senior management of local insurers will not only need to have a greater appreciation of the risk issues involved, but must also be able to

manage a greater alignment between business strategy and risk” (The Star News, January 13, 2011). However, the duties of aligning the business strategies and inherent risks should rest on the shoulder of the Chief Risk Officer who oversees the risk management in the corporation. The board may better appreciate the risk involved when they have a Chief Risk Officer to advise them during board meetings. This best practice of appointing a Chief Risk Officer should be further expanded to the other industries and public-listed corporations.

In short, it is undeniable that the Chief Risk Officer is central to the sound internal control system of a corporation due to his roles and responsibilities to the governance system. Having the right integrity and independence, he is not only the eyes and ears of shareholders who may not be involved in the daily operation of a corporation but he may also act as the alarm call for any red flags of misconduct or problem in the corporation. Hence, such warnings are important in preventing any untoward malpractices that may affect minority interest.

### **5.11.3 Revamping Audit Process**

If a Chief Risk Officer is deemed to be the second line of defence for minority shareholders, the audit committee and auditors of a corporation would perceive themselves as the last line of defence for shareholders. This is because most auditors will only find out the financial irregularities prior to the quarterly and annual financial reporting of a corporation for a particular year. However, it is high time that the auditors should change such a mindset in moving towards becoming the frontier of protection for minority shareholders. Even if the auditors only discover the financial irregularities at a



later stage of the governance system, they may play their role to prevent such misdeed from depriving minority interests.

Most of the time, an auditor will always rely on the accounting reform made by the country in the hope for better accounting and auditing principles. It is not sufficient to have a set of comprehensive accounting principles in place when corporation merely complies with them in form and not in substance. Notwithstanding the accounting reforms in Korea, Choi (2001) was still pessimistic about the actual outcome from such reform where the “accounting cultural environment still remains qualitatively not very much different from what it used to be before the crisis”. Hilb (2006) highlighted the flourishing of “creative auditing” cases that led to corporate malfeasances. Such “creative auditing” includes share manipulation, fraudulent financial reporting and overstatement of revenue. He proposed that board auditing function should be enhanced via various monitoring mechanisms of supervision, controlling and examination. The discussion on the case studies of Enron and Transmile scandal in chapter 3 clearly necessitates the significance of auditors since auditors’ failure to exercise duty of care and diligence was one of the reasons of corporate collapse. As such, there is an ardent need to revamp the entire internal and external audit process.

In this context, Fan and Wong (2001) identified several reasons why external auditors are not effective in monitoring the corporation. It was argued that the most significant reason is due to the inefficacy of the audit committees in selecting the external auditors. The authors blamed the regulatory frameworks in Asia that failed to ensure that the external auditors are motivated to be independent and credible in monitoring the corporation. A myriad of corporate malfeasance cases also showed that boards sought to shift the burden of auditing and supervision of the corporate accounts to the appointed

auditors. Auditors are mostly blamed by the board for their refusal to issue an audited report in time. Looking at the duties of an auditor, it is clear that they will only be able to form their opinion on the affairs of a corporation if there is adequate documents and sufficient information as provided by the corporation. Such inordinate delay in submission of audited financial statements to the authority may be partly caused by missing documents, insufficient data and figures, inappropriate accounting principles, detection of fraudulent records or reluctance of auditors to tailor the report based on the whims and fancies of the board.

In the Malaysian High Court case of *Teoh Peng Phe v. Wan & Co.* [2001]<sup>31</sup>, Kang Hwee Gee J recognised that auditor is the watchdog of the company by quoting the statement of Walter Woon, the author of *Company Law*, 2nd Edn: “If he smells a rat, he must bark.” The *Teoh Peng Phe* case is topical as it addresses the relationship between an external auditor and the corporation as the watchdog in relation to the affairs of the corporation. However, most auditors, in practice, do not really act as the watchdogs of the corporation they are engaged with. It is an anomaly to say that external auditors would oversee the affairs of the corporation since they are only obliged to express their opinion on whether the financial accounts of the corporation reflect a fair and true view of the state of affairs of the corporation. Obviously, they are not involved in the day-to-day operation and activities of the corporation. Most often than not, their opinions pertaining to the financial accounts of a corporation are heavily formed based on the documents, receipts, invoices, vouchers and other accounting records presented to them by the audit committee or the board. As a result, it is very difficult to ascertain the accuracy of the figures and statements as well as the authenticity of the documents provided for examination. To make matter worse, external auditors often chose not to

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<sup>31</sup> [2001] 5 CLJ 222.

disclose any information related to any inconsistency in the financial statements in order to maintain the business relationships with the corporation.

Pertaining to the audit process, the audit committee is expected to be accountable to the corporation, in particular minority shareholders, for ensuring that their financial interests are protected. Even though the external auditors are considered as outsiders to the corporation, they are equally required by law to exercise their utmost professionalism in carrying out duties of auditing. It follows that there are several governance best practices that may improve the audit process in a corporation:

- a) The audit committee and the external auditors should always wear the coloured sceptical glasses in inspecting the underlying financial information of a corporation.
  - i. Ho (2003) was of the view that an auditor must be sceptical while examining the records and transactions shown by the management but they are not expected to look into the genuineness of those transactions. This view is not really acceptable in the modern world when fictitious sales and inflated figures are the order of the day. The external auditors should not merely discharge their duties by stating in their reports that the financial statement presents a “true and fair view” of the corporation’s financial status. Rather, they should actively perform verification on the accuracy and authenticity of those transactions or financial information given by the management. This can be done with the similar culture of scepticism in the audit committee. Such questioning mindset should not be seen as a challenge to the authority

and entrustment of the management. It should be perceived as an injection of professionalism objectivity in the audit process without causing unfriendly environment.

- ii. In essence, scepticism touches on the verification of information via forceful question, independent examination of the sources and focused attention to discrepancies. Hence, the practice of scepticism may enhance the integrity of the management and board ethics in the audit process.

b) It is of utmost importance that the audit committee should preserve their integrity as an independent watchdog over the affairs of the corporation.

- i. With regard to the independence of the audit committee, Felo, Krishnamurthy and Solieri (2003) commented on Enron case where they were six experts in its audit committee – an accounting emeritus professor, an accounting professional and two top executives of other firms. However, it is interesting to note that the Enron’s audit committee failed to detect the accounting abnormalities of the corporation since they had obviously relied on the authenticity of financial data provided by the management.

- ii. In *Sheahan v. Verco* (2001)<sup>32</sup>, the Australian Supreme Court ruled that “directors cannot be required to make their own further investigations or to ‘audit’ the accounts provided, unless they have particular responsibilities or expertise, and they can only be required to seek more

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<sup>32</sup> (2001) 79 SASR 109.

information if the company's accounts, together with any other information from the company's executives, put them on enquiry". The audit committee should regularly seek financial information from the management or the board rather than doing so at the end of the financial year.

- c) The board should review the composition of the audit committee in order to determine its qualification and independence. It should be ensured that the audit committee members are qualified in terms of knowledge, experience and expertise in effectively carrying out their duties. Financial literacy test may be performed upon the audit committee so that they are aware of the financial and accounting issues concerning the business of the corporation. If they are not found to be lack of competency, the audit committee should be mandated to attend more training and education programs to enhance their financial literacy. As for purpose of independence, the board may also engage the service of independent advisor in restructuring the composition of the audit committee to include more independent members such as the independent auditors, financial consultants and the legal experts.
- d) Non-executive directors should also actively advise the audit committee in their capacity as a director who owes a fiduciary duty to the corporation. Since they are not involved in the daily management of the corporation, they are in a better position to exercise their independent judgment. Adillah, Zulkarnain and Shamsheer (2006) noted that "the non-executive directors in the office of the audit committee perform an advisory function to the executive directors and are expected to exercise the standard of care and skill of the person in that position".

Aiman (2009) argued that the non-executive directors breach their duty of care if they fail to obtain information pertaining to the financial status and activity of the corporation. She was of the view that it is not the duty of the auditors to warrant that all the financial statements provided is accurate since it is the duty of directors to prepare the statements correctly. Hence, it is strongly proposed that the audit committee in a corporation should be composed of the non-executive directors and independent directors.

- e) There shall be change of cultural tone at the top. The New York's Blue Ribbon Committee report (1999) recommended that the "performance of audit committees must be founded in the practices and attitudes of the entire board of directors". The board should send the clear message across the whole corporation that fraudulent audit practices are strictly prohibited and those who have committed the same will be reported to the relevant authority for further criminal actions. The board should also set a good example of integrity, independence, ethics and scepticism.
- f) The board should help to nurture communication between the audit committee, management, internal auditors and external auditors beyond the scheduled meetings. Such close collaboration would ensure that the monitoring mechanisms are effectively implemented. Chtourou, Bedard and Courteau (2001) opined that for the sake of independence and competence, the audit committee should be active in holding meetings with the management and board. A direct reporting mechanism should be created so that those who involve in the audit process may communicate with each other without any barrier or bureaucratic issues.

- g) The audit committee should have an effective oversight of the internal auditing process. The internal audit function is essential to the execution of the committee's governance best practices. An internal audit charter may be designed to pledge the loyalty of the internal auditors towards the corporation that they serve. Their values are certainly different from that of the external auditors who are not the integral of the corporation. Hence, the internal auditors shall demonstrate the same integrity of independence and professionalism in their audit approach and reporting duties.

In this regard, it will be important to step up measures on internal control within a corporation as part of good corporate governance best practices to protect minority shareholders. Having stronger presence and voice, the institutional investors should also play their eminent role as part of the shareholder activism. It is important that “institutional investors should implement greater internal controls to monitor their corporate governance programs, redirecting the resources expended on activism to their highest valued use” (Romano, 2000). The Illustration 5.8 below succinctly sums up the foregoing discussion on the best practices of internal control in a given governance system of a corporation.

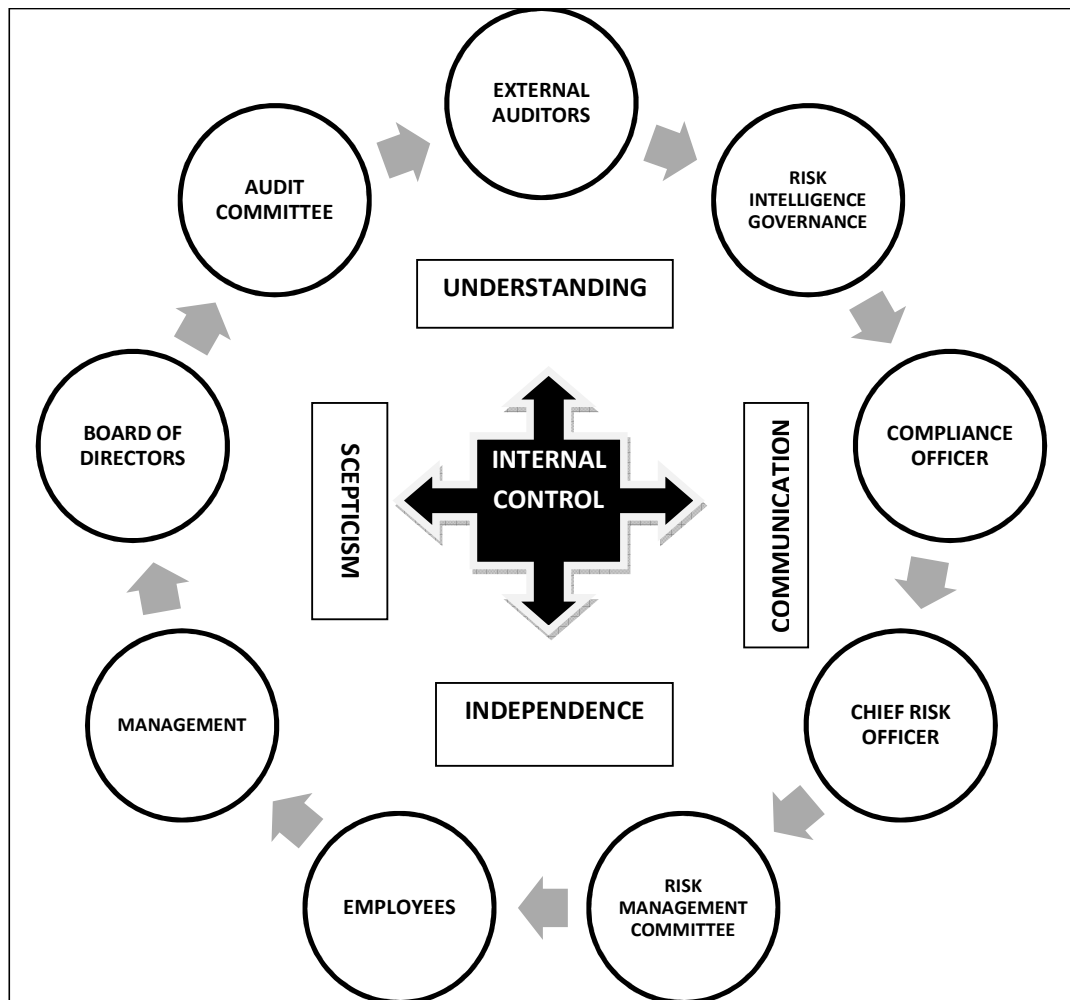


Illustration 5.8: Best practices of internal control

### 5.12 Lifting the Corporate Veil to a New Level of Accountability – Redefining Separate Legal Personality

A corporation may have a comprehensive internal control system, full board disclosure and transparency as well as increased shareholders' rights and powers based on the discussion above. However, the fact remains that directors and managers come and go. It is shareholders and other stakeholders who will end up with huge losses and debts if a corporation is not well-managed due to corruption and corporate malpractices. Even if a corporation may have an excellent business model or bright investment prospect, there



is still no guarantee that the corporation will be safe from any malpractice on the part of the board and management. Notwithstanding that a corporation may have an effective implementation of the corporate governance best practices amongst the board and the management, it still requires a highly responsible team of board and management to create long-term value for its shareholders. As such, the focus on corporate governance should be on “finding the optimal level of liability to be imposed on company directors and officers” (Harris, 2008). Nonetheless, it is a mind-boggling game to find the optimal level of liability to be imposed on directors and officers of a corporation since there is no single standard of fiduciary duties which is often subjected to the court’s interpretation. To make matter worse, the notion of “separate legal personality” seems to provide a broad shield for directors to evade from their responsibilities. Therefore, it is significant to ascertain the objective and purpose of “separate legal personality” before delving into corporate governance best practices of lifting corporate veil for enhanced board accountability. It is noted that the notion of “separate legal personality” is used in the entire context of discussion here as it may be used interchangeably with the words “separate legal entity” elsewhere.

In relation to the “separate legal personality”, Hofmann (2005) elaborated that the board is conferred with excessive powers and control as a corporation cannot act without the executives or directors once it came into existence. Blair and Stout (2006) added that a corporation may legally own the assets acquired through the capital and borrowings of the investors and creditors for the purpose of business expediency. Such legal ownership of assets unknowingly creates a situation where the assets of a corporation may be abused by directors or management via siphoning out of money or transfer of assets to themselves. As a result, shareholders often find that the corporation they

invested in turns out to be a mere empty shell loaded with enormous debts and liabilities when they decided to exit from the corporation.

Most often than not, the general court approach in Malaysia has inclined towards casting aside the “separate legal personality” rule and lifting the corporate veil in order to “have a crack at it to do justice” - *Yap Sing Hock & Anor. v. Public Prosecutor* [1993]<sup>33</sup> and *Law Kam Loy & Anor v. Boltex Sdn Bhd & Ors.* [2005]<sup>34</sup>. Courts had also pierced through the corporate veil in cases where the notion of “separate legal personalities” was used to evade contractual obligations by using a corporation as a “mere cloak or sham” - *Sunrise Sdn. Bhd. v. First Profile (M) Sdn. Bhd. & Anor.* [1997]<sup>35</sup>. However, it is noted that court will only do so in exceptional cases as stated in the case of *Ong Thean Chye & Ors v. Tiew Choy Chai & Anor* [2011]<sup>36</sup> where “the courts will respect the company’s integrity and will decline to lift the veil of incorporation”. In terms of corporate governance best practices, the notion of “separate legal personality” is still considerably useful for directors to evade responsibilities as the court only looked at the corporate structure, true ownership and control, exceptional fraudulent cases and other purposes of justice. Often, courts overlooked the facts that directors failed to exercise their business judgment in the best interest of the corporation as well as breached their fiduciary duties by cloaking under the notion of “separate legal personality”.

All in all, it can be deduced from the foregoing arguments and cases that the notion of the “separate legal personality” has gradually evolved into a tool which provides directors and management the opportunity to exploit a corporation for their own

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<sup>33</sup> [1993] 1 BLJ.

<sup>34</sup> [2005] 3 CLJ.

<sup>35</sup> [1997] 1 CLJ.

<sup>36</sup> [2011] 1 CLJ.

benefits. The unscrupulous board may also use a corporation to shield them from any arising liability from their misbehaviour or misconducts. In the United State Court of Appeal case of *Grayan Ltd* [1995]<sup>37</sup>, Henry L.J. ruled that “the concept of limited liability and the sophistication of our corporate law offer great privileges and great opportunities for those who wish to trade under that regime”. As such, it is highly unlikely that any losses suffered in the event of corporate failure will be borne by directors and management unless the malpractice falls under the exception to the “separate legal personality” where clear intentional fraud or blatant disregard of statutory duties can be proven.

As a result, it can be said that the Solomon principles on “separate legal personality” do not favour the application of corporate governance best practices. Speaking of this, directors will not be held liable for any losses or liabilities incurred onto a corporation unless there is any intention to defraud the corporation. Directors seek to hide behind the corporate veil of Solomon principle to escape from such liabilities or breach of business judgment rule. As such, board accountability is largely restricted to the principles laid down in the Solomon case. In this regard, it is imperative that sound corporate governance practices should be implemented to take a corporation to a new level of board accountability. The remainder of this section will discuss on the appropriate application of the principles of “business judgment rule” and “fiduciary duties” in lifting the corporate veil casted by the “separate legal personality” notion.

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<sup>37</sup> [1995] Ch 241, 257.

### 5.12.1 Refining the Business Judgment Rule

This section seeks to redefine the statutory business judgment rule and to translate its proper application into the corporate governance best practices. The nexus between the statutory rule and governance best practices will be thoroughly considered for the purpose of determining a new level of board accountability to the corporation. Hence, it is necessary to first decipher the statutory business judgment rule as enshrined in the Malaysian company law in order to further scrutinise the application of this rule under the *Corprimacy* norm.

Since the inception of the business judgment rule in Malaysia, it has always been perceived by the corporate world as a safe haven that protects directors from being held accountable for their business judgments as long as it is made with honest and reasonable belief that the it is in the best interest of the company and for a proper purpose. In essence, the business judgment rule is “a presumption that in making a business decision, directors of a corporation acted on an informed basis in good faith and in the honest belief that the action was taken in the best interests of the company” (*Aronson v. Lewis*, 1984). In other words, the board of directors’ decisions would be effectively safeguarded from liability for any breach of their duty of care so long as there is proper basis that supports the decision whereby all material information readily available to the knowledge of the board has been taken into account in the decision making process. As such, it seems that the rule has unknowingly provided an alternate back door for directors to hide their evil actions behind the corporate veil and to pursue their personal interest underneath the boardroom carpet.

Nonetheless, the American Law Institute's Principles of Corporate Governance (1992) observed that the main basis to support the existence of the business judgment rule is due to the need “to protect honest directors and officers from the risks inherent in hindsight reviews of their unsuccessful decisions, and to avoid the risk of stifling innovation and venturesome business activity.” Hansen (1993) explained that the core principle of the business judgment rule is deference to directors' decision-making based on judicial reluctance to review a business decision and to avoid directors from being risk averse in their decisions or actions. In *Alaska Plastics, Inc. v. Coppock* (1980)<sup>38</sup>, it was expressed in such a way that business judgment rule represents the fact that “judges are not business experts”. This is the reason why judges are reluctant to override the board's judgment provided that the board decision is reasonable. In this regard, the reference to the term “judges are not business experts” in that case would mean that the court will abstain itself from second guessing the directors' business decisions as the court also recognises “judicial restraint and abstention” (Bainbridge, 2004) for there is a need to shield directors from liability for the risky ventures necessary for corporate survivorship.

Although the need for the business judgment rule is not disputed here, the general perception of “safe haven” would be altered accordingly if the rule is revisited in the context of *Corprimacy*. In the true legal sense, this “safe haven” does not simply mean that the directors' duties are relaxed to the extent that directors may make decisions or take corporate actions according to their own whims and fancies. Instead of being considered as a “safe haven”, the rule shall be interpreted as to provide the court a yardstick to examine a director's business judgment in order to determine whether a director has satisfactorily discharged his duties with the requisite level of skill, care and

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<sup>38</sup> 621 P.2d 270 (Alaska 1980).

diligence. Moreover, there is no concrete evidence to show that corporate performance would deteriorate if directors are not protected from being personally liable for erroneous business judgment. By way of analogy, high standard of duty of care in other fields of practice does not seem to deter qualified professionals like lawyers and doctors from making wise judgments so long they are made based on the relevant professional skills, knowledge and ethics. Such duty of care and skill is codified as the fiduciary duties in the company law.

To satisfy the requirement of statutory fiduciary duties, Section 132(1B) of the Companies Act 1965 succinctly spells out the need to exercise the business judgment rule in accordance to the principles of good faith for a proper purpose, the duty to avoid material personal interest in the subject matter of the business judgment as well as the reasonable belief that the business judgment is an informed judgment and in the best interest of the corporation. From the perusal of this provision, it can be seen that the significance of the term ‘business judgment’ cannot easily be ignored in determining whether the director has breached his duty of reasonable care, skill and diligence. The subject matter of a business judgment is essential to the existence of the business judgment rule. This is because the business judgment rule would not be applicable if the director does not make a business judgment in practice. Moreover, the requirement of ‘business judgment’ is clearly embedded in all four essential elements that constitute the fulfilment of the duty as stipulated under 132(1B) of the Companies Act 1965. In this context, the term “business judgment” is broadly defined under Section 132(6) of the Companies Act 1965 to mean “any decision on whether or not to take action in respect of a matter relevant to the business of the company”. Directors must have exercised his judgment in relation to the business affairs of a corporation only in order to invoke the use of the business judgment rule as a protection from breach of director’s duties. In

other words, the rational exercise of judgment by the director concerning the business of a corporation is an important condition precedent of the rule. This is the first step in determining whether the director has made the business judgment in the best interest of the corporation.

Secondly, Section 132(1B)(a) states to the effect that if a director has made the business judgment in good faith for a proper purpose, he will be shielded from liability for breach of his duty even if these judgments turned out badly. With regard to the principles of good faith and proper purpose, Section 132(1) of the Companies Act 1965 provides that “a director of a company shall at all times exercise his powers for a proper purpose and in good faith in the best interest of the company”. Prior to the amendment of Companies Act 1965 in 2007, the original provision read as “A director shall at all times act honestly and use reasonable diligence in the discharge of the duties of his office”. The scope of the duties and liabilities of a director has since be widened and clarified in a more business sense.

As embedded in Section 132(1) of the Companies Act 1965, both the principles of good faith and proper purpose are considerably crucial in determining whether directors had really acted in the best interest of the corporation. This is because the two principles form part and parcel of the provision as it uses “and” for them to be read conjunctively. In the United Kingdom’s case of *Howard Smith Ltd v Ampol Petroleum Ltd* [1974]<sup>39</sup>, the directors were held liable for breach of duties as the transaction has been motivated by some improper purpose regardless of the fact that they had acted in the best interest of the corporation. In that case, the directors had exercised their powers to allocate shares to another corporation which had made an offer to bid in a takeover transaction.

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<sup>39</sup> [1974] AC 821.

It was alleged by the directors that the said allotment was intended to raise capital for the corporation. However, it was proven otherwise that the directors had allotted the shares with the intention to yield powers over the entire corporation. As evident by the aforesaid case, a director will still be liable under Section 132(1) of the Companies Act 1965 if the transaction was intended for other collateral purpose which was improper with regard to its purpose even though it may be done in good faith in the best interest of the corporation. Hence, the directors may exercise their powers for purposes other than those related to the transaction as long as the purposes were intended to benefit the whole corporation. The test of “good faith” was also subsequently laid down by the House of Lords to mean the “bona fide exercise of the power in the interest of company” without any motivation of self-interest. Hence, the directors have the duty to avoid any conflict of interest in order to exercise their business judgment in good faith.

Thirdly, corporate governance best practices tend to equate “business judgment rule” with good quality of decision-making process. To enhance the quality of decision making process, it is proposed here that the element of commercial sense should be injected into the “business judgment rule”. The Chairman of the Australian Securities and Investments Commission, Lucy (2006) addressed the commercial reality of the directors’ legal responsibilities that a director “should pursue the commercial objectives of the company to whom you are responsible in a manner consistent with meeting your legal obligations”. In *Grimes v. Donald* (1996)<sup>40</sup>, the Delaware Court provided an example of how commercial reality shall be read into the business judgment – “a board which has decided to manufacture bricks has less freedom to decide to make bottles. In a world of scarcity, a decision to do one thing will commit a board to a certain course of action and make it costly and difficult (indeed, sometimes impossible) to change course

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<sup>40</sup> 673 A.2d 1207, 1214-15 (Del. 1996).



and do another”. In this regard, a board may not simply change their decision if it does not make commercial sense to do so. In other words, a board is required to make good business decisions that are not in contravention with the law. To be honest and fair, a director should not seek refuge behind the protection of the business judgment rule so long that the decision makes commercial sense.

Similarly, the business judgment rule in Singapore is rather relaxed in the sense that the court would be reluctant to interfere with the decision of a director as it would not be flexible and commercial viable to do so. In *ECRC Land Pte Ltd v. Wing On Ho Christopher* [2004]<sup>41</sup>, the Singapore court viewed that “the court should not substitute its own decisions in place of those made by directors in the honest and reasonable belief that they were for the best interest of the company, even if those decisions turned out subsequently to be money-losing ones”. Based on strong policy considerations, it was also observed by VK Rajah JC in *Vita Health Laboratories Pte Ltd and Others v. Pang Seng Meng* [2004]<sup>42</sup> that:

It is the role of the marketplace and not the function of the court to punish and censure directors who have in good faith, made incorrect commercial decisions. Directors should not be coerced into exercising defensive commercial judgment, motivated largely by anxiety over legal accountability and consequences. *Bona fide* entrepreneurs and honest commercial men should not fear that business failure entails legal liability. A company provides a vehicle for limited liability and facilitates the assumption and distribution of commercial risk. Undue legal interference will dampen, if not stifle, the appetite for commercial risk and entrepreneurship.

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<sup>41</sup> 1 SLR 105.

<sup>42</sup> 4 SLR 162.

As we can see, the judicial approach in Singapore has also underpinned the *Corprimacy* norm that this dissertation propounds to be the adopted in formulating a new model of corporate governance in Malaysia. Comparatively, the underlying principles of business judgment rule are that of “good faith” and “commercial probity”. Although directors are not supposed to be legally reprimanded to make correct commercial decision, they should adopt the best practice of making judgment that makes commercial sense and creates values for the corporation.

Fourthly, should any conflict of interest arise, the director is obliged to act in the best interest of a corporation in a way that promotes the principles of *Corprimacy*. Blair and Stout (1999) argued that “the business judgment rule also requires directors to demonstrate that they honestly believed they were acting in the best interests of the company.” The business judgment rules would not be applicable in situation where a director does not make an informed and independent decision based on what he considers in good faith to be best interest of the corporation. Hence, it is necessary that a director should prioritise the best interest of a corporation in exercising their business judgment. This best practice strikes in consonance with the *Corprimacy* notion that corporation should be managed for the interest of all shareholders and other stakeholders involved. In doing so, Blair (2003) observed that directors should consider the impact of their decision upon every stakeholder in terms of the overall goals of the corporation.

Last but not least, a director can be held personally liable for failing to exercise his business judgment in good faith for the best interest of the corporation. In the United

States case of *Joy v. North* (1983)<sup>43</sup>, the court ruled that “the fact is that liability is rarely imposed upon corporate directors or officers simply for bad judgment and this reluctance to impose liability for unsuccessful business decisions has been doctrinally labelled the business judgment rule”. The court recognised that the business judgment rule has sheltered the directors or officers from liability for making bad judgment. On this note, Bainbridge (2003) reiterated that it is important to have a proper balance of accountability and authority in a governance system. He was of the view that accountability and discretionary authority are both interdependent of which the “directors cannot be held accountable without undermining their discretionary authority”. However, the issue of personal accountability is not about taking away the discretionary power of directors in deciding on a subject matter. Accountability speaks of the personal responsibility of a director in exercising his business judgment in a manner that is accountable to the corporation. It is intended to hold those responsible personally liable for the acts or purported acts of the corporation. A director should seek to strike a balance between his discretionary authority and his accountability to a corporation as both these elements should go in parallel with one another. The Illustration 5.9 below represents the necessary balancing act of a director in avoiding personal liability for his action or decision.

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<sup>43</sup> (1983) 460 U.S. 1051.

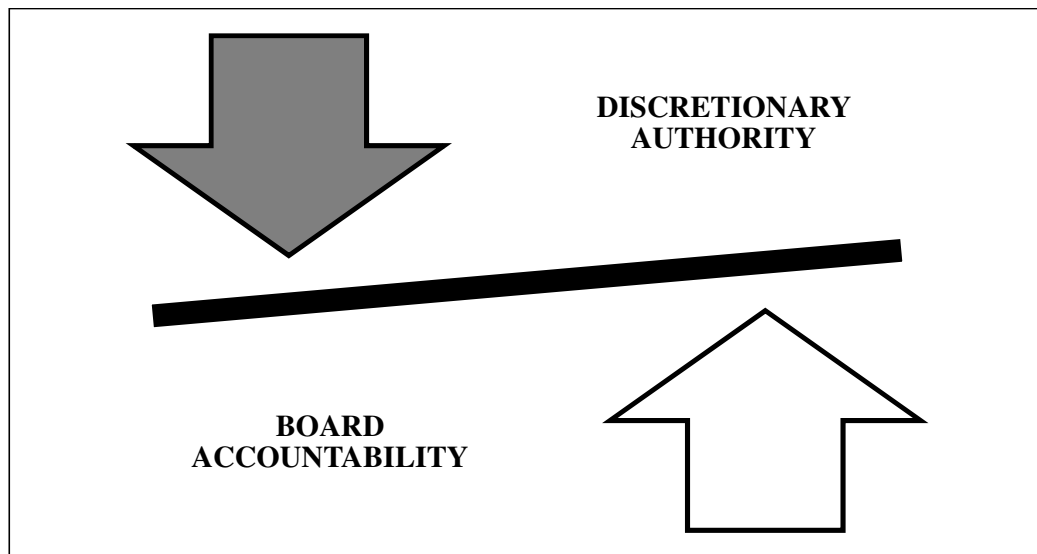


Illustration 5.9: Balancing act between the discretionary authority and the board accountability

Whilst the ‘business judgment rule’ was initially introduced in 2000 in Australia, Greenhow (1999) clearly elucidated the reason why the word ‘judgment’ is used instead of ‘decision’ as the latter only connotes majority decision made by the board whereas the word “judgment” represents judgment of the individual directors sitting in the board. To put it simply, directors rely on their personal business judgment to reach a particular finding which may or may not lead to the final board decision. Such individual business judgment is not binding upon the board as it remains the assessment of each director before voting for or against the majority decision. Hence, it is the personal exercise of judgment by a director that is in question when it comes to personal accountability. There is no reason why a director may not be held personally accountable for his breach of business judgment rule. In the Australian case of *Clackwell v. Moray* [1991]<sup>44</sup>, the Supreme Court was of the view that “the abandonment of any proper consideration of relevant facts, the admitted failure to exercise an independent discretion and the mere doing of what was thought that the majority shareholder wanted cannot in these

<sup>44</sup> [1991] 5 ACSR 255.

circumstances have amounted to the bona fide exercise of discretion required of a director”. In other words, directors should put on their thinking cap and critically examine the facts presented to them whilst exercising their discretion in good faith. They shall not merely rubber-stamp the majority board decision without first exercising their business judgment. In view of the new level of personal accountability, directors are no longer allowed to hide behind the business judgment rule.

However, the court in the Singapore case of *Planassurance PAC Formerly known as Patrick Lee PAC v Gaelic Inns Pte Ltd* (2007)<sup>45</sup> held that the directors are not personally accountable for the “accuracy and integrity of all of a company's financial statements”. It is sad to note that the learned judge obviously failed to consider the significance of business judgment rule where the directors shall seek to make an informed judgment on the accuracy and authenticity of the financial records. As directors of the corporation, they may not allow the auditors or management to exercise the business judgment on their behalf. This is because they owe the fiduciary duties towards the corporation as a whole. This point has been reaffirmed in the case of *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.* (1991)<sup>46</sup> in which the duties of director are reinstated as fiduciaries to the corporation and its stakeholders as a whole. It was stated that “the board had an obligation to the community of interest that sustained the corporation, to exercise judgment in an informed, good faith effort to maximize the corporation’s long-term wealth creating capacity”. This judgment rhymes in tandem with the notion of *Corprimacy* in which directors owe fiduciary duties to consider the best interest of a corporation including its stakeholders as a whole. Harping back on the rationale behind the business judgment rule, it is clear that its application is intended to strike a balance between corporation maximising shareholder wealth by

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<sup>45</sup> [2007] 4 SLR 513.

<sup>46</sup> Civ. A. No. 12150, 1991 Del. Ch. Lexis 215 (Del. Ch. Dec. 30, 1991).

making innovative business decisions while creating a comprehensive model of governance and corporate management structures based on the gist of *Corprimacy*.

In regard of the business judgment's standard, the test remains an objective one and will differ following the size, structure and nature of the business of the particular corporation. For instance, the business judgment rule applies differently in these two most commonly found corporate structures in Malaysia, namely the public listed corporation and private corporations. This is due to the fact that the responsibilities the directors shoulder in both structures of such entities vary from one and another – on one hand, public listed corporations usually entail directors to assume the supervisory role whilst on the other hand, most of the private corporations require directors to perform both the managerial and governance functions. As such, this new level of accountability may assist the court in objectively determining whether directors have breach their statutory fiduciary duties and business judgment rule based on their compliance with the corporate governance best practices. The Illustration 5.10 below shows that the corporate governance best practices are formulated to facilitate directors in properly and responsibly discharging their statutory duties.

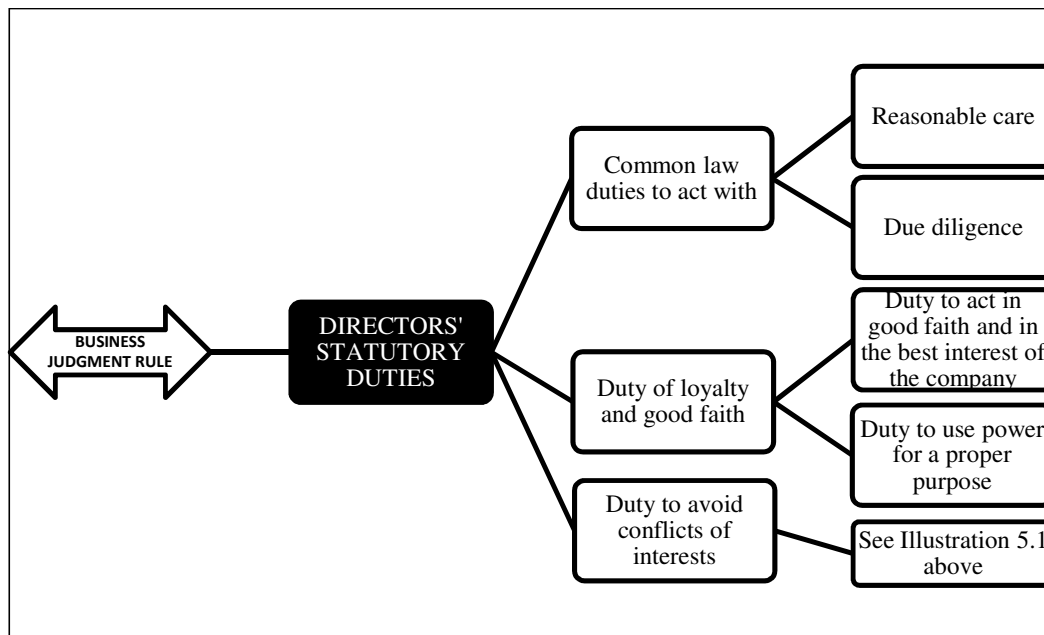


Illustration 5.10: Interrelation between the business judgment rule and the directors' statutory duties

In short, *Corprimacy* notion requires directors to be considered as one legal personality with a corporation in practice. As part of the governance best practices, corporate veil should be lifted when directors failed to exercise their business judgment in good faith for the best interest of the corporation. The *Corprimacy* approach towards the terms “best interest of the corporation” has been discussed at length in chapter 4 of this dissertation. Furthermore, they may also breach the business judgment rule if their judgment does not make commercial sense to a corporation. Such new level of accountability may protect minority shareholders from the business catastrophe created by those directors who breached the business judgment rule. It bypasses the exception to the Solomon principles where minority shareholders are vulnerably protected until the court ruled in favour of intentional fraud on the part of the directors. Further, it is important to tie this business judgment rule with the knot of enhancing the fiduciary duties for the purpose of higher board accountability.

### 5.12.2 Enhancing the Fiduciary Duties

To further lift the corporate veil, the notion of *Corprimacy* encourages the enhancement of directors' fiduciary duties via the formulation of corporate governance best practices. The court will have to look at the governance best practices of a corporation to peep behind the veil of incorporation.

Having superior power over shareholders, the board is statutorily bound to manage the corporations on behalf of shareholders based on the principle of separation of ownership and control. Given the power of decision-making, the board has wide discretion in directing and managing the affairs of the corporation. Bainbridge (2002) described this “statutory decision-making model” as “one in which the board acts and shareholders, at most, react”. Most often than not, corporate faces the verge of downfall when directors betrayed the duty of loyalty that is entrusted onto them by the corporation and its shareholders to manage and direct corporate affairs in the best interest of a corporation (Blair, 2002). Denis and McConnell (2003) commented that although the board is established to employ, dismiss, supervise and remunerate the management, board efficacy is hardly seen in practice. As such, it is vital to create an efficient board that strictly adheres to the corporate governance best practices as part of their fiduciary duties.

In relation to the directors' fiduciary duties, Arrow (1974) sought to advocate a new level of accountability corresponding with the relevant authority of an organ in the corporation. It was termed as “management by exception” where the management decisions are “reviewed only when performance is sufficiently degraded from



expectations”. To put it simply, the board will not manage a corporation by default but will only do so based on exceptional mismanagement. The board will not question the decision of the management unless there is some unexpected deterioration in the corporate performance. Such irregular board supervisory mechanism may not be the best practice in lifting the corporate veil in governance related matters. If a board senses any unsatisfactory corporate performance at any one point of time, it is their duty to identify the problem and sort it out with the management before everything is too late.

Although this practice of “management by exception” may save the board ample time so that they may focus on other board policy issues, it is the board’s continuous duty to supervise the management and direct a corporation in the event of mismanagement. Manning (1984) stated that most board action “does not consist of taking affirmative action on individual matters; it is instead a continuing flow of supervisory process, punctuated only occasionally by a discrete transactional decision.” There shall not be any break in the supervisory chain of the board notwithstanding that the management is delegated with the authority to manage the corporation. The board should regularly monitor and correct any error in the management. In the United Kingdom’s case of *Re Barings Plc (No 5)(2000)*<sup>47</sup>, the Court of Appeal held that “the exercise of the power of delegation does not absolve a director from the duty to supervise the discharge of the delegated functions.”

To facilitate the discharge of fiduciary duty by the directors, an officer of a corporation should also be trustworthy and honest in managing the corporation. They should not hide any information that may affect the decision-making process of the board. German (2009) opined that “because the corporation can only act through its board of directors,

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<sup>47</sup> [2000] 1 BCLC 523 at 535.

officers owe a duty of complete candor to the board so that the board can make informed decisions in managing the business of the corporation”. As such, *Corprimacy* requires that the management owes a duty of candor to the corporation that they serve.

At times, the management team will find ways to conceal facts and information from the boardroom. Such concealment may be driven by personal interest, fear of board despise, instruction of CEO and other factors. It is always too late when corporate performance drops drastically and act of malpractice starts to unfold in the corporation. In this context, it is apparent that the board owes a duty to oversee the information disclosed by the management as well as to closely watch over the conducts of the management. Directors will be considered to have breached this duty if they unreasonably relied on the information without making independent assessment and verification. Be that as it may, the board faces mounting challenges to examine the accuracy of any disclosed information due to the lack of independence from the CEO who also sits in the board as a director. In view of this, it will be even harder for the board to confront the management team on facts or information which is “swept under the office’s carpet”. Such hidden information is not easily available or accessible by the board who has duly delegated the authority of management to the officers of the corporation.

Marshall and Beltrami (1990) argued that “the company's system of control is often dependent on the close involvement of the directors, who are better acquainted with the employees and officers. If there is fraud by an employee of the company, a director may be more likely to have his suspicions aroused than would his counterpart in a large, anonymous, public company.” Although it may be correct to say that the justification of directors’ reliance on the management is correlated with the size and structure of the

corporation involved, it should not be a valid reason for a director to rely unreasonably on the management in a public corporation. This is due to shareholders' expectation that the board of directors will exercise their utmost function as a supervisory board. What more when it is a public-listed corporation, directors bear higher responsibilities and duties to ensure that the management is vigilantly monitored and constantly supervised. As huge shareholders' interests are at stake, the level of accountability and transparency on the part of the board should increase accordingly.

In the effort to avoid conflict of interest, it is proposed that directors should not abuse their knowledge and position in taking advantage of such conflict for their personal benefits. The duty to avoid conflict of interest was reaffirmed in a Malaysian High Court case of *Pharmmalaysia Bhd v. Dinesh Kumar Jashbhai Nagjibha Patel & Ors* [2004]<sup>48</sup> where Abdul Malik Ishak J quoted the words of Charlesworth and Cain on *Company Law* (12th edn) at p. 371 that "the fiduciary duties of directors are to exercise their powers for the purposes for which they were conferred and *bona fide* for the benefit of the company as a whole and not to put themselves in a position in which their duties to the company and their personal interests may conflict". However, such duty to avoid conflict of interest may be amplified via the governance best practices of refraining from using the director's fiduciary position to reap benefit out of any conflict of interest. It can be seen in the Australian case of *Hospital Products Ltd v. United States Surgical Corporation & Ors* [1984]<sup>49</sup> where the High Court illustrated that "a fiduciary is liable to account for a profit or benefit if it was obtained: (1) in circumstances where there was a conflict, or possible conflict of interest and duty; or (2) by reason of the fiduciary position or by reason of the fiduciary taking advantage of

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<sup>48</sup> [2004] 7 CLJ 465.

<sup>49</sup> [1984] 55 ALR 417.

opportunity or knowledge which he derived in consequence of his occupation of the fiduciary position”.

Furthermore, a director is required to adopt the governance best practices of actively participating in a meeting in order to remain sceptical about the information provided by the management. Samsar (2007) commented on the foreign judicial view pertaining to the fiduciary duty of care that a director owes to the company. He explained that the test of objectivity has been applied in the Australian case of *Daniels v Anderson* (1995)<sup>50</sup> where the duty varies according to the size of the corporation and the experience of the directors. On the other hand, the English case of *Re Cardiff Savings Bank* [1892]<sup>51</sup> (*The Marquis of Bute's*) held that the directors owe a higher duty to exercise their business judgment by making recommendations during board meetings than merely attending those meetings. It means that directors would breach their duties of care for not actively participate in the board meetings.

Moreover, failure by a director to probe further into the affairs of a corporation whether by negligent or otherwise should be regarded as a breach of duty. It is required that a director should have an “inquiring mind” in supervising corporate affairs (*Vita Health Laboratories Pte Ltd v Pang Seng Meng*, 2004)<sup>52</sup>. This is due to the reason that negligence or failure to act on the part of the director may show bad faith in making decisions. In *Ryan v. Gifford* (2007)<sup>53</sup>, the United States Delaware court ruled that bad faith of directors “may be shown where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary

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<sup>50</sup> (1995) 16 ACSR 607.

<sup>51</sup> [1892] 2 Ch 100.

<sup>52</sup> [2004] 4 SLR 162, at 171.

<sup>53</sup> 918 A.2d 341, 345 (Del. Ch. 2007).

intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties”. Although individual director may not be held liable for the decision or actions of the other directors, Victor (2001) opined that they should voice out their differing opinions pertaining to the decision of the other directors or take affirmative measures to prevent any such decision from materialising.

In the event of financial difficulties, directors owe fiduciary duties to the creditors of the corporation. This should be similarly applicable to the management where the duty of enhancing shareholders value would shift towards preserving value for creditors when a corporation faces financial crisis (Apreeda, 2002). In a Singaporean case, *Tong Tien See Construction Pte Ltd (in liquidation) v Tong Tien See & Ors* (2002) 3 SLR 76, the court recognised the duties of director to the creditors during financial instability of the corporation. It was said that “when a company is insolvent, the interests of its creditors become dominant factor in what constitutes the benefit of the company as a whole”. The aforesaid case speaks of the interest of creditors that should represent the benefit of a corporation as a whole when a corporation is insolvent. The rationale behind the judgment of the case is fairly understandable as directors may not simply dispose of the company assets. This is due to the reason that the creditors have the right over the assets of the corporation when it is at the stage of liquidation and winding-up.

In conclusion, directors should be refrained from seeking refuge behind the notion of “separate legal personality” as well as the “business judgment rule” as they should bear higher level of accountability to the corporation and shareholders as a whole. However, some scholars viewed that the increase in board accountability is likely to have adverse effect that could shy away competent candidates from joining the board of a corporation due to fear of exorbitant liabilities on the brink of prestige and perquisites. Harner (2009)

argued that “this tension can lead to ‘carrot’ or ‘stick’ proposals to encourage good corporate governance”. One must understand that lifting the corporate veil to impose higher board accountability will not create a situation of ‘carrot’ or ‘stick’ proposals to promote good corporate governance. This is due to the simple reason that higher board accountability will necessitate higher commitment to the duties entrusted upon directors to oversee and direct the affairs of the corporation. Neither the failure of management to disclose any information nor the incompetence of management should be an excuse used by the board to escape from liability. If any director feels that they are not at par with the standard of governance best practices, they shall relinquish their directorship post or refuse to hold any such post. Good corporate governance practices shall not give way to the ease of board hiring at the expense of the best interest of the corporation.

By looking at the governance best practices in the corporate charter, the court will not hesitate to find directors personally liable for their breach of business judgment rule and the fiduciary duties owed to the corporation at large. Recently, the Court of Appeal upheld the 6-month imprisonment upon the former directors of MEMS Technology Berhad who knowingly authorised the submission of misleading financial statements to the Bursa Malaysia which involved over RM30 million fictitious sales. In fact, one of the directors was also the substantial shareholders of the company. As we can see from this case, the general court approach of merely examining the corporate structure and control has gradually been directed towards the corporate governance best practices of a corporation. Such shift of approach is aimed to determine whether the majority shareholders who are also the directors on the board have duly exercised their business judgment to act or decide in good faith for the best interest of the corporation. It is necessary to protect minority shareholders who have no board representation at all. The

Illustration 5.11 below clearly addresses the lifting of corporate veil in board accountability.

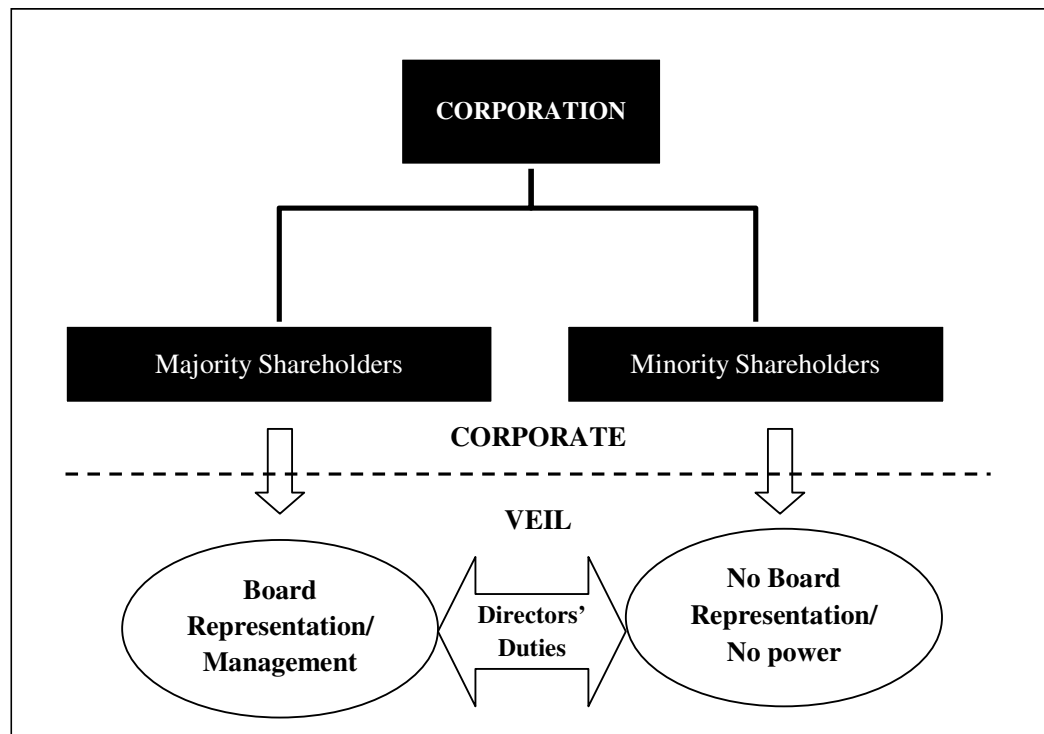


Illustration 5.11: Corporate veil in board accountability

### 5.13 Conclusion

Desirably, an optimal corporate governance structures should be designed to balance the rights of various stakeholders of a corporation without jeopardising the rights and interests of shareholders or compromising the creative thinking of directors in their decision making process. In a nutshell, the foregoing discussion has critically examined and spelled out a set of corporate governance best practices that promote such balanced decision-making process without compromising the board accountability and independence. Accordingly, this set of best practices is formulated in the concluding chapter 6 where its primary objective is to protect minority shareholders. All these best

practices will eventually lead to higher transparency and board accountability as shown in Illustration 5.12 below.

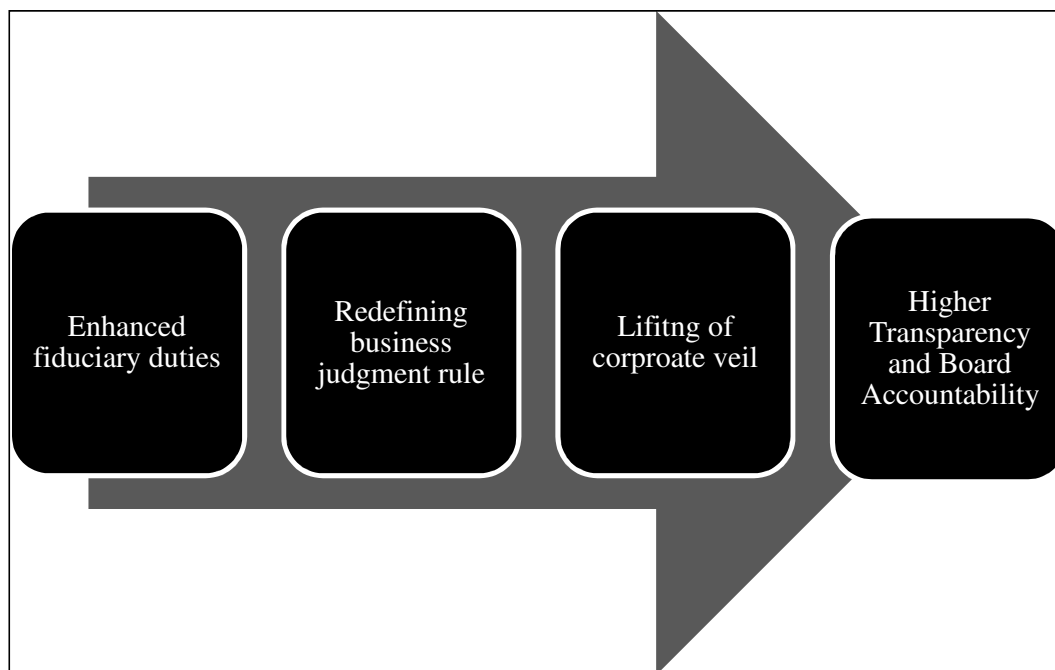


Illustration 5.12: Path to higher transparency and board accountability



## CHAPTER 6

### RESULT:

#### FORMULATION OF CORPORATE GOVERNANCE BEST PRACTICES

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##### 6.1 Introduction

The background to this study has been addressed in chapter 1 of this dissertation where literature review was carried out to identify the knowledge gap in the existing governance-related literatures of which the research question and objectives were established. Corporate governance principles and issues were also succinctly laid down in chapter 2. In this regard, the current development of Malaysian corporate governance framework was also examined in chapter 3 to highlight its defects in protecting minority shareholders. Following this, chapter 4 moved on to create the new paradigm of *Corprimacy* which has laid down the concept behind the formulation of corporate governance best practices in this dissertation. Such formulation of best practices was discussed at length in chapter 5 and thus, this chapter extracted the said best practices for the purpose of formulating a set of corporate governance best practices.

As can be seen from the case studies discussed in previous chapters, the lack of compliance with the corporate governance best practices has led to weak protection of minority shareholders. Hence, it is of utmost importance to formulate a set of corporate governance best practices that would act as the golden parachute for the successful landing of minority shareholders on corporate goldmine. The words “golden parachute” is used as part of the title of this dissertation in order to indicate the need for minority shareholders to equip themselves with the necessary tool before a corporation collapses.

If and when the corporate governance best practices set forth in this dissertation are effectively and properly implemented, these practices will be able to act as protective measures for minority shareholders.

## **6.2 Formulation of Corporate Governance Best Practices**

With regard to the research question on what are the corporate governance best practices that could be implemented to protect minority shareholders, the study in this dissertation has led to the formulation of a set of corporate governance best practices consisting of 10 key areas of best practices that should be incorporated into the existing Malaysian corporate governance framework. Such research question is in line with the research objectives of this dissertation which have also been achieved in terms of formulating corporate governance best practices for the protection of minority shareholders.

As outlined in Illustration 1.1 in chapter 1, there are 7 essential elements that constitute the pillars of corporate governance best practices. Bearing in mind these pillars, the remainder of this chapter spelled out the formulated set of corporate governance best practices based on the main thesis of this dissertation – the protection of minority shareholders based on the discussions and analysis made in this dissertation.

### **6.2.1 Avoiding conflict of interests**

This study brings to light that avoiding conflict of interests is one of the essential elements of interaction under the pillar of best practices. Recognising the potential conflicts of interests between the board and minority shareholders within a corporation,

this dissertation proposes 4 best practices that a director should adhere to in managing the conflicts of interests:

1. The board should enhance the disclosure requirement for related-party transactions via the extended disclosure of any person who is known to a particular director. The director should disclose any person that he knows of in a transaction for the best interest of the corporation. This includes friends or their family members that a director is associated with. It will then be left to the board to decide whether the disclosed interest would adversely affect the best interest of the corporation as a whole. Currently, Section 131 of Companies Act 1965 merely requires the disclosure of persons connected (as defined in Section 122A) to the interested directors in a related-party transaction.
2. The board should implement a sound response system that could actually enable directors to quickly identify and resolve any conflict of interests within a corporation. Directors should first understand the types and natures of the conflicting interests faced by the corporation so that the best interest of the corporation is upheld. The directors must be able to identify the potential conflict of interest with their current core business activity as a result of any contradictory commercial interest.
3. A Chairman, who is also the director of the corporation, should abstain from chairing all board and management meetings in connection with any related-party transactions.

4. The board should seek the opinions, advices or valuation from an external independent party or professionals regarding all transactions affecting the interest of shareholders, especially minority shareholders. In all decision-making process relating to the interest of minority shareholders or related-party transaction, a board should be inculcated with the highest possible business ethics and sound corporate culture for strict self-discipline and constant board regulation since they are accountable to the corporation as a whole under the concept of *Corprimacy*.

#### **6.2.2 Enhanced board disclosures and transparency**

This study also finds that enhanced board disclosure and transparency are considered as one of the key rudiments of disclosure and transparency under the pillar of best practices. In this regard, this dissertation highlights 4 best practices that would provide minority shareholders with the opportunity to savour their investments as well as sufficient notice to act rationally and swiftly in the event of any imminent corporate scandal:

1. The board should disclose to the Bursa and the public pertaining to the various factors that they have considered in justifying that a particular transaction is in the best interests of a corporation by going beyond mere statement of “best interest of the corporation and its shareholders”.
2. A director is obliged to disclose any interest or connection that he may have or know of in a particular transaction including any third party interest directly or indirectly related to him that may be at variance with

the interest of the corporate entity as a result of the transaction. It should be extended and not limited to only related-party transaction and interested matters.

3. The board should disclose all the information relating to the background and identity of the actual beneficial owners of the shares held by their nominees.
4. The board should implement enhanced disclosure best practices which are beyond the mandatory disclosure requirement set under the Bursa's Listing Requirements.

### **6.2.3 Increased integrity of independent directors**

This study also observes that board disclosure and transparency could be enhanced with the increased integrity of independent directors as it represents the element of board of directors and committees under the pillar of best practices. This dissertation recommends 8 best practices that uphold the integrity of an independent director:

1. An independent director shall possess the necessary skill, knowledge and experience to independently assess the board decision based on the intrinsic value of the subject matter discussed in board meeting. They shall be able to stand on their own feet whilst making individual decision.
2. The independent directors shall uphold their integrity by using their knowledge and experience to detect any irregularity in the board decision or action.

3. An independent director shall have the minimum qualification or working experience on business administration or financial matters or at least possess some basic knowledge on the business activity of the corporation that they are hired.
4. The board shall regularly conduct assessment test upon the independent directors to determine whether they are still capable of exercising independent mind whilst making decision within the board. If they are not able to be truly independent, the board should consider replacing them with new independent directors.
5. The independent directors shall constantly acquire more relevant information regarding the business activities and financial affairs of a corporation even if they are merely independent non-executive directors of the corporation.
6. An independent director should not accept whatever information fed by the board or management during meetings. But they should carefully sieve through the information and critically scrutinise them in the presence of the board.
7. The independent directors should adhere to the statutory business judgment rule whilst deciding in the best interest of the corporation. They should introduce elements of objectivity and impartiality into the board decisions due to their independent stand.

8. The Chairman of a corporation should be an independent director in order to ensure that independence starts at the helm.

#### **6.2.4 Modernising board independence from the management**

This study also reveals that modernised board independence constitutes the element of monitoring under the pillar of best practices. This dissertation suggests 6 best practices that promote modernised board independence:

1. The board shall be independent from the influence and control of the management apart from self-independence within the board.
2. The board shall have an inquiring mindset whilst relying on the information given by the management. The board shall actively query such information in order to form their own independent and informed judgment.
3. The Chairman could be the one who sets the right tone and precedent in the board since they often have the final say to reject or accept the proposal by the management.
4. The board should seek to avoid the situation of CEO duality where the CEO is also the managing director or the Chairman and director of the corporation. In other words, the board should ensure that the roles of the chairman and CEO are not assumed by the same person in the corporation.

5. The CEO shall not act as the chairman during board meetings in order to warrant that the board could be totally independent from the influence of the management.
6. The board shall maintain a healthy professional working relationship with the management team in a corporation as they should not get too personally attached with the CEO or other top executives. Such professional relationship will ensure that the board is able to challenge the actions of the management whilst exercising their monitoring function over the affairs of the corporation.

#### **6.2.5 Active Board Involvement in Strategic Planning and other Management related matters**

This study also discovers that active board involvement in strategic planning and other management related matters forms the element of monitoring under the pillar of best practices. This dissertation advocated 4 best practices that encourage such active board involvement:

1. Directors should actively participate in the process of charting the course for corporate planning and strategies, rather than merely rubber-stamping the proposed corporate plans submitted by the management.
2. Directors shall endeavour their best to obtain as much information as possible from the management or other sources on a regular basis. The board should understand that having the best corporate strategies does



not necessarily lead to the implementation of best practices. It is the quality of the information that the board acquires that would lead to the formation of corporate strategies which are in the best interest of the corporation.

3. The board shall not unreasonably rely on the information given by the management in the course of charting the strategic planning and policies for the corporation.
4. The board should form a collaborative working relationship with the CEO in term of strategy setting and policy formulation. This does not mean that the CEO should take over the board's role of formulating strategies and policies. It is rather a win-win situation of beneficial partnership in managing and directing the corporation.

#### **6.2.6 Corporate Cultural Reform and Board Ethics**

This study also propounds that corporate cultural reform and board ethics reflect the elements of business practices and ethics under the pillar of best practices. This dissertation advances 11 best practices that stimulate such cultural and ethical reform:

1. The board shall undertake to set the tone from the top to bottom via the formulation of a set of board ethics and governance standard within the corporation.

2. The board shall gradually depart from the corporate cultural norms of complying with the majority rather than voicing out one's constructive dissent and views.
3. The Chairman shall encourage the board to generate more contentious arguments during board discussions or meetings.
4. Dissenting views of directors shall be recorded in the board minute and the rejection of the views by the board shall be reasonably explained thereafter. This is to create a constructive board discussion on one hand and to prompt more directors to have their own views rather than sticking to a pack of "yes" directors. At the end of the day, proactive debate amongst directors is the intended objective.
5. The Chairman shall play the vital role of building up his very own confidence and reputation amongst the board in order to gain respect and trust from his fellow directors. He shall be able to point out the wrongdoings or other acts of non-compliance with the corporation's governance best practices which are committed by any director.
6. The Chairman shall act fearlessly in convening an inquiry team to independently pursue investigation on any suspected corporate malpractices or complaints received from within or outside of the corporation.

7. The board may invite representatives amongst the employees or staffs in a corporation to channel their concerns and opinions pertaining to a particular board action or decision. To do this, the board must convince the employees that they may confide in them pertaining to any matters that would affect the best interest of the corporation.
8. The board shall set the tone from top in enforcing substance over form when it comes to implementing the best practices of corporate governance. This would inadvertently create a commendable culture in which the employees may trust the board to exercise their supervisory authority in the best interest of the corporation.
9. The board should portray good leadership and ethics to the entire corporation in order to improve board efficacy in upholding good business ethics.
10. The board shall form a group of independent representatives from the employees that acts as an intelligence-gathering team for the corporation in order to stimulate whistle-blowing and good corporate culture. The team may also provide routine feedback gathered from the employees directly to the board on the improvement to the governance system within the corporation.
11. The board should draft their Article of Association based on the *Corprimacy* notion that the best interest of a corporation is the pivotal consideration. It should include a set of corporate governance best

practices that bind the relationships amongst the members of the corporation.

#### **6.2.7 Shareholders' Rights and Powers**

This study also contemplates that shareholders' rights and powers articulate two elements of monitoring and interaction under the pillar of best practices. This dissertation puts forward 4 best practices that attest to shareholders' rights and powers:

1. The board should move away from the “comply or explain” principle in implementing corporate governance best practices. The board would have to explain and convince shareholders that it is in the best interest of the corporation not to comply with certain best practices.
2. The board shall devise a set of corporate governance best practices which suits the corporation and disclose their full compliance with the best practices in the annual report.
3. The board should also explain to shareholders on the actions taken to implement the best practices and the reasons for any non-compliance with the best practices. It is recommended that such governance best practices shall form part and parcel of the corporation's Article of Association.
4. The board should allow shareholders to have more say in corporate strategic decisions and corporate governance related matters. Shareholder

representatives may be invited by the board to attend board meetings on the corporate strategies and governance related matters.

5. Prior to any AGM, shareholders should be given the opportunity to submit to the corporation their proposals on various corporate governance issues so that such issues can be discussed during the AGM.
6. Directors should ensure that the investor relations are regularly discussed amongst the board, management and shareholder representatives in order to enhance shareholder communication.
7. The board shall maintain regular engagement with shareholders apart from the general meetings in order to provide timely information pertaining to the affairs and activities of the corporation. The board may also obtain constructive feedback or response from shareholders on relevant issues affecting the corporation.
8. Board engagement with shareholders may also be enhanced via the adoption of technology, namely teleconferencing, video conferencing, emails and other electronic communication.
9. The Chairman shall briefly educate shareholders of their rights to participate, vote and challenge the board during the general meetings.
10. The board shall seek to create a transparent nomination process that accommodates the voices of shareholders. Although the board is in a

better position to understand the need of a corporation, there shall be a good mix of directors consisting of industry experts, financial and business professionals as well as selected representatives from amongst shareholders, in particular minority shareholders.

11. The board shall encourage shareholders to actively participate in the board nomination process by creating a proxy access rule for shareholders to nominate their choice of directors in the corporation. Such proxy access rule may be implemented via the establishment of procedures for the inclusion of shareholders' director nominations in the corporation's agenda.
12. The board shall implement a proxy disclosure best practice which allows a corporation to reason out why each director is nominated based on their qualification and background.
13. The board shall consult with shareholders with regard to the selection of candidates for directorships by the nomination committee before the whole voting process takes place. The mechanism for such consultation may be established according to the procedures explained in sub-chapter 5.9.2 of this dissertation.
14. The Nominating Committee shall consist mostly of independent directors and shareholder representative.

15. The board shall ensure that shareholders are provided with the avenue to vote on the corporation's agendas via a proper electronic mechanism or other convenient channel in the event that they are not able to attend the general meeting.

#### **6.2.8 Executive remuneration policy**

This study also demonstrates that executive remuneration policy proves to be the element of board of directors and committees under the pillar of best practices. This dissertation enunciates 8 best practices that ensure a transparent and reasonable executive remuneration policy:

1. The remuneration committee should spell out the executive compensation policies and packages in details in the annual report.
2. The board should devise some models of executive compensation based on reasonable quantitative and qualitative criterions that benefit a corporation in the long run.
3. The board should implement the policies on "say on pay" where shareholders are given the right to vote on the remuneration policy and package of a corporation. Such vote to amend the policy may be binding or advisory in nature depending on the needs of the corporation.
4. The board should adopt the share retention policy where the rewards of stock options are given in parts to the executives over a span of few years.

5. The board should not subdue to the management pressure on the remuneration policy of the executives.
6. Board remuneration policy should be structured to compensate and reward directors based on long-term commitment approach.
7. The board should exercise their business judgment to decide on the executive remuneration packages based on the best interest of the corporation.
8. The Remuneration Committee shall consist of all independent non-executive directors and shareholder representatives.

#### **6.2.9 Internal control**

This study also postulates that there are 3 crucial sub-areas under the main umbrella of internal control which constitute the element of risk performance and management under the pillar of best practices. They are as follows:

##### **6.2.9.1 Integration of Risk intelligence governance**

This dissertation pointed out 20 best practices that create an integration of risk intelligence governance:

1. The board should define the scope and level of different existing and potential risks posed to a corporation.



2. The board should set a strong tone at the top for independence, professionalism and ethical culture as an example to the auditors and the management in their efforts towards fraud prevention and reporting system.
3. The board should craft a crisis management plan by taking into account of the risks the company faces whilst weighing their consequential effects upon a corporation in the short run and the long run.
4. The board should evaluate the risk performance and risk governance structure between the board and the committees.
5. The board should hold frequent meetings or robust dialogues with the responsible risk officers and committees to further comprehend the underlying risks in relation to the business activities and management of a corporation.
6. The board should chart a plan for close collaboration and coordination amongst all the departments within a corporation via a risk intelligence sharing system.
7. The board should designate the risk management committee as the central control of risk intelligence and management.

8. The board should educate the officers and staffs in a corporation. All employees should be trained to understand the risks exposure and how to cope with such risks as well as what amounts to fraud and how to effectively report any suspicious fraudulent acts from bottom to the top.
9. The board should restructure the composition of the risk management committee which is usually consists of directors rather than other officers in a corporation.
10. The board should review the risk management policies and strategies regularly and benchmark the policies with the latest development in other countries.
11. The board should design a proper guideline or manual on effective risk monitoring and management for the reference of a corporation.
12. The board should shoulder the responsibilities of risk oversight as part of their fiduciary duties to a corporation.
13. The board should review the financial standing of a corporation regularly to determine whether there is any financial over-leveraging or over-gearing problems such as excessive borrowings from creditors in comparison with the corporation's assets and capacities to pay back the borrowings.

14. The board should implement an internal anti-fraud control and reporting system to detect fraud and corporate malfeasance.
15. The board should appoint an independent compliance officer to act as a whistleblower for the external fraud reporting system.
16. The board should implement the use of information technology system that would enhance the financial or fraud reporting mechanism without exposing the true identity of the whistleblower.
17. The board shall always weigh their business decisions against the corporation's risk appetite. Any deviation from the risk measure set by the corporation shall not exceed the bearable risk exposure of the corporation. In other words, thorough risk-benefit analysis shall be meticulously carried out by the board and the management prior to any major decision or action that may affect the operation of the corporation.
18. The board shall put in place a mechanism for crafting of risk strategy, regular measurement of risk exposure level and constant revision of risk policy.
19. There shall be a clear separation of roles between the risk management committee and the risk management department.
20. The board should appoint a Chief Risk Management Officer from the board to undertake the risk oversight role.

#### **6.2.9.2 Chief Risk Management Officer**

This dissertation emphasises on 2 best practices relating to the duties and roles of a Chief Risk Management Officer:

1. The Chief Risk Officer is mainly to identify and access any risk accrued to the company's operations including tabling risk assessment reports to the board on a timely basis.
2. Depending on the level of the risk exposed, the Chief Risk Officer may promptly decide to take actions or measures to contain and reduce the risks without going through the board.

#### **6.2.9.3 Revamping audit process**

This dissertation underscores 8 best practices that push for the reform of audit process:

1. The audit committee must be sceptical while examining the records and transactions shown by the management. They should actively perform verification on the accuracy and authenticity of those transactions or financial information given by the management.
2. The audit committee should regularly seek financial information from the management or the board rather than doing so at the end of the financial year.

3. The board should review the composition of the audit committee in order to determine its qualification and independence. It should be ensured that the audit committee members are qualified in terms of knowledge, experience and expertise in effectively carrying out their duties. Financial literacy test may be performed upon the audit committee so that they are aware of the financial and accounting issues concerning the business of a corporation. If they are not found to be lack of competency, the audit committee should be mandated to attend more training and education programs to enhance their financial literacy. As for purpose of independence, the board may also engage the service of independent advisor in restructuring the composition of the audit committee to include more independent members such as the independent auditors, financial consultants and the legal experts.
4. Non-executive directors should also actively advise the audit committee in their capacity as a director who owes a fiduciary duty to a corporation.
5. The board should send the clear message across the whole corporation that fraudulent audit practices are strictly prohibited and those who have committed the same will be reported to the relevant authority for further criminal actions.
6. The board should help to nurture regular communication and close collaboration between the audit committee, management, internal auditors and external auditors beyond the scheduled meetings.

7. The audit committee should have an effective oversight of the internal auditing process. An internal audit charter may be designed to pledge the loyalty of the internal auditors towards the corporation that they serve.
8. External auditor shall be regularly reviewed by the board based on its independence and merits and if need be, changed in order to maintain audit professionalism and board responsibility.

#### **6.2.10 Board accountability**

This study also asserts that board accountability shapes the core element of legal and regulatory under the pillar of best practices. This dissertation sets forth 15 best practices that champion higher board accountability:

1. The board should adopt the best practice of making judgment that makes commercial sense and creates values for a corporation.
2. Should any conflict of interest arise, the director is obliged to act in the best interest of a corporation in a way that promotes the principles of *Corprimacy*.
3. The board should consider the impact of their decision upon every stakeholder in terms of the overall goals of a corporation.
4. The Chairman should ensure that each director is personally accountable for individual decision or action.

5. A director is required to adopt the governance best practices of actively participating in a meeting in order to remain sceptical about the information provided by the management.
6. Directors should bear an inquiring mind towards the papers and reports submitted by the management. They should probe behind the data and figures provided in order to obtain the correct information. With such information in hands, the directors would be able to direct more incisive and challenging questions towards the integrity of the management.
7. Directors owe fiduciary duties to the creditors of a corporation in the event of financial difficulties or insolvency.
8. A director should act like an owner of a corporation who masters the knowledge of the industry and business involved. A director may not be expected to have the sector expertise but he should at least develop the knowledge as regards the art of business in the industry.
9. Attending training on the skills of managing a company will not be sufficient for the directors to first know the company business and the industry dynamics. Directors should be prepared to roll up their sleeves to visit the factories, to actively acquire information on the business operation, to meet their customers or clients and so on. Deeper understanding on the corporate operation and policy as a whole would definitely increase the directors' contributions to board discussions or meetings.

10. Responsible board stewardship does not end on the basis of “noses in, fingers out” where directors only direct the corporate policies and strategy development whilst the management implements them in carrying out the business activities of a corporation. Directors should shoulder personal responsibilities in steering the governance mechanism of the corporation which includes risk monitoring, internal control, executive remuneration and so forth. This goes back to the fundamental roles of directors in governing and overseeing the entire corporation. In other words, a director shall be a leader that holds responsible stewardship which shapes the governance best practices of the corporation.

11. Directors should not rush on making hasty decisions on the key issues affecting the business and operation of a corporation. Due to only several meetings per year, directors should have control over the agenda of their board meeting via prioritisation of important matters to be discussed. The setting of agenda should not be left at the absolute discretion of the management team.

12. Directors should manage their board meetings effectively by not divulging too much time on usual management issues and insignificant operational matters. Rather, more attention should be given to strategic discussion on setting key performance targets, executing risk management measures as well as reviewing their strategies and policies according to the business development of a corporation. The meeting



shall comprise more of fruitful discussion than lengthy briefings or presentations by the management. For this, directors shall be well-equipped with the necessary information and issues at hand before attending any board meeting.

13. The board should be responsible in ensuring that they have full access to company information that is timelier and of higher quality via a proper implementation of centralised information access system for the board.

14. The board should not simply discharge their duties and responsibilities due to their busy schedule of works or constraint of time to probe further. If the board requires more company-provide support assistance, they should not hesitate to hire more research staffs to assist them on complicated corporate matters prior to board discussion in meetings. This support system will also lead to more constructive board discussions.

15. The board should also conduct annual key performance assessment of each director in order to measure the extent of individual contribution and accountability to a corporation as a whole.

### **6.3 Conclusion**

In short, board accountability, independence and integrity are the principles that shall be the hallmark of corporate governance best practices for the protection of minority shareholders. Be that as it may, all the aforesaid best practices cannot stand alone. They

must be collectively implemented as a whole in order to afford full effective protection to minority shareholders. For instance, one of the corporate governance best practices stated above empowers shareholders to present their views or suggestions to the board regarding corporate governance issues within a corporation during the general meetings. However, such enhancement of shareholder democracy and involvement will not sustain without the implementation of responsible board stewardship. An irresponsible board leadership will choose to ignore shareholders views and restrain their involvement in the general meeting. Hence, it can be inferred that the combination of all best practices will make the golden parachute of minority shareholders stronger and safer for a successful landing of minority shareholders on corporate goldmine.

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